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*In this number :
Financial situation
of European enterprises*

SUMMARY AND CONCLUSION

Manufacture industries

- 1. The profitability of European manufacturing enterprises improved in 1995, but less strongly than in 1994.***

The performance of European manufacturing enterprises, as measured by the gross operating profit ratio and the net profit ratio, improved by 0.5 percentage points between 1994 and 1995. Companies' profitability regained their 1987 levels, and almost reached the level of 1988/1989, record year for the performance of European companies. However, these good results have to be qualified. Firstly, the pace of improvement was lower than in 1994. Secondly, although improvement of European firms' profitability performance in 1995 was better than that of American firms, nevertheless the latter's performance clearly remain better than that of their European counterparts. Indeed, the gap between Europe and the United States has even become historically high by this measurement. This is partially because of divergence between the business cycles in the United States and the European Union.

- 2. The evolution of European enterprises' costs diverged in 1995: the share of purchases of goods and services grew whilst that of financial charges remained stable, staff costs declined significantly.***

The slowdown in the improvement of European firms' performance has many causes. Firstly, 1995 saw a pause in the growth of European industrial production, following a sharp upturn in 1994. Secondly, the share of purchases of goods and services in turnover markedly increased after several years of stability. Thirdly, financial charges, whose contraction largely contributed to profitability improvements in the two preceding years, stabilised in 1995.

However, thanks to efforts of wage moderation, 1995 saw a significant decline in the weight of European enterprises' staff costs, down 1 percentage point between 1994 and 1995. The level of staff costs was 1.4 percentage points under the 1985–1993 average. This fall is even more marked in percentage of value added, down 2.5 percentage points.

3. ***For the first time since 1990, European firms' financial profitability in 1995 exceeded nominal long term interest rates.***

In 1995, the financial profitability of European enterprises (9.6%) exceeded the nominal long term interest rate¹ (8.4%) by 1.2 percentage points. The reason was the conjunction of improved financial profitability and stable long term interest rates from 1993. This situation may have influenced the choices facing investors between shares and bonds and helped contribute to the excellent performance of European stock markets since 1995. In the United States, the positive gap between firms' financial profitability and nominal long term interest rates was historically high.

4. ***Against this background, European firms continued to consolidate their financial structure.***

In 1995, European enterprises' own funds ratio stabilised at 33.6%. Generally, the last ten years have seen some relative convergence within the triad. The overall indebtedness ratio markedly decreased in Europe and in the USA. The share of long term debt in total debt remains, however, significantly higher in the United States and Japan than in Europe.

Sectoral analysis

5. ***European companies' profitability varies widely across sectors but their trends are similar (except for building and transport and communication).***

The 5 sectors analysed (manufacturing, building and civil engineering, trade, transport and communication, other services) register a wide gap in their gross profit ratios and financial profitability. On average, over the period 1986–1995, their gross profit ratios ranged between 5.6% (trade) and 22.9% (transport and communication), their financial profitability between 5.6% (building and transport and communication) and 10.4% (trade). However, 3 out of 5 sectors (with the exception of the building and transport and communication sectors) have evolved in similar ways since the second half of the 80s. By contrast, decreasing public demand and reinforced competition on public procurement markets may have affected the building sector's profitability negatively, especially in Italy, the United Kingdom and France.

6. ***These sectoral differences in performance can partially be explained by the different structures of balance sheets across sectors.***

Sectors with large shares of fixed assets (such as transport and communication) typically have large shares of long term loans. Large investments in fixed assets also tend to be combined with higher own funds ratios, because the need for risk sharing is greater. Gross profit ratios tend to be larger in such sectors because part of the profit will be used for depreciation and value adjustments. Furthermore, competitive pressures on such sectors might be less intense because fixed costs (sunk costs) are large, discouraging potential entry.

7. ***Cost structures also differ significantly across sectors.***

At one extreme, expenditure on purchases of goods and services relative to turnover (86%) in the trade sector is high, whilst staff costs (9%) and financial charges (2%) are relatively small. At the other extreme, purchases of goods and services (52%) by the transport and communication sector are relatively low, whilst staff costs (33%) and financial charges (7%) are relatively high.

SME versus LE performances

8. ***Small and medium-sized European enterprises' (SMEs) profitability is generally slightly lower than that of large enterprises (LEs), and the gap has increased over the recent period. However, there are wide differences across Member States (see also point 12).***

Over the last 10 years, European SMEs' gross and net profitability has generally been slightly lower than that of LEs. Similar conclusions are only true for financial profitability in recent years. Moreover, in 1995, European SMEs' profitability remained at 1994's level whilst LEs' profitability increased. As a result, the gap between SMEs' and LEs' net profitability in 1995 was historically wide. LEs seem to have a better capacity than SMEs to benefit from periods of economic recovery. Apart from 1994–1995, the trend for European SMEs' profitability has generally been downward. For LEs in Europe, profitability is cyclical, and no general downward trend can be observed.

9. ***The importance of staff costs for European SMEs might explain why their performances lag those of LEs.***

These two size-categories' differences in profitability seems to be explained, in Europe, by the structure of their costs. LEs use more intermediate consumption in their manufacturing process than SMEs. However, this comparative advantage in favour of SMEs is offset by the weight of staff costs, which is much higher in SMEs than in LEs: in 1995, for instance, the share of staff costs in turnover was 25% for SMEs, but only 19.3% for LEs. Other factors, such as access to capital markets may also have an influence.

10. ***European SMEs appear less capitalised than LEs and rely more on debt for financing.***

In 1995, as in the previous ten years, LEs' share of own funds exceed that of SMEs. Symmetrically, SMEs' overall debt ratios were much higher than those of LEs: 11 percentage points higher in 1995. European SMEs appear less capitalised than LEs, possibly explained by their difficulties in obtaining equity capital funding. European SMEs prefer to finance projects by self financing or loans.

¹ Yield on benchmark 10-year bond.

More precise analysis shows a clear trend of decreasing indebtedness, which is more important for LEs than for SMEs. This period corresponds to high levels of interest rates in Europe, suggesting that firms have tried to reduce their indebtedness in order to cut their financial charges. LEs may have been more successful than SMEs thanks to access to a wide variety of financing sources. On the other hand, SMEs have to rely more on the banking system as access to alternative sources of financing is rather limited.

- 11. American SMEs have a different financial structure than European SMEs – more own funds, less indebtedness – and contrary to European SMEs, they enjoy better financial profitability than LEs.**

In the United States, SMEs appear to be more capitalised than LEs: over the period 1986–1995, their own fund ratio was approximately 46%, higher than the corresponding ratio for LEs (43%); the opposite is true in Europe. Similarly, their ratio of indebtedness (overall and financial) is lower than that of LEs. This could reflect the organisation of US capital markets, particularly the success of venture funds devoted to SMEs. Easier access to capital markets might contribute to the good financial profitability of American SMEs: between 1985 and 1995, their financial profitability (15%) was 5 percentage points above that of LEs.

- 12. In some Member States, SMEs' profitability is either similar to that of LEs (Austria, Germany, France, Italy and the Netherlands) or even better (Spain).**

Concluding that SMEs' profitability is lower than that of LEs is valid only for 5 of the 11 Member States analysed (Belgium, Denmark, Portugal, Sweden, the United Kingdom). In 5 other countries (Austria, Germany, France, Italy and the Netherlands) SMEs' profitability is similar to that of LEs, whilst in Spain, their performance is superior. However, no common characteristics emerge for those countries where SMEs perform relatively well, except that the financial charges facing SMEs and LEs are relatively equivalent, whereas they are higher for SMEs in the other Member States.

- 13. SMEs' financial structures are weaker than that of LEs in all Member States (except the United Kingdom and, to a lesser extent, Spain) to varying degrees.**

SMEs' financial structures are substantially weaker than those of LEs in Austria, Denmark, Germany, Portugal and Sweden. SMEs have lower own funds ratios and higher total indebtedness and financial indebtedness. In Austria, Germany and Sweden, however, these differences have mainly been caused by large provisions for pensions and liabilities in LEs. By contrast, in Belgium, France, Italy, the Netherlands and Spain, SMEs' financial structure was only modestly weaker than in LEs. The United Kingdom is an exception as SMEs have a financial structure more similar to that observed in the United States: i.e., UK SMEs are characterised by higher own fund ratios and smaller indebtedness than LEs. Unlike the United States, the lower indebtedness in the United Kingdom does not result in better performance of UK SMEs.

INTRODUCTION

This supplement to European Economy provides, on the basis of enterprise-level financial information (see box 1 on BACH), an annual comparison of the performances and financial structures of enterprises in the EU Member States, the United States and Japan.

This fourth issue includes three main parts. The first part analyses the performances of European, American and Japanese enterprises (gross, net and financial profit), their charges (intermediate consumption, staff costs, financial charges) and their financial structure (own funds ratio, overall debt and structure of debt). The second part offers a sectoral analysis. This is the first time that the supplement has not been exclusively focused on manufacturing industry but also includes developments in four other sectors: building, trade, transport and communication and other services. Finally, the third part compares the performances and balance sheet structures of small and medium sized enterprises with those of large enterprises.

It should be emphasized that this study's objective is to present a *descriptive* analysis of enterprises' financial performance and structures, not to enter into *theoretical* debates on links between corporate finance, enterprise performances and balance sheet structures. The Bach-database's comparative advantage is to permit international comparisons and the purpose here is to present and comment on such comparisons. Nevertheless, the results presented here should be treated with caution as the data still lacks complete comparability because of differences in accounting practices, inadequately representative samples and statistical inaccuracies. Data quality is best for manufacturing industry. Coverage of service sectors is poorer and may not always be representative. The 'other services' sector is particularly poorly covered.

Box 1: Business accounts harmonized data bank (BACH)

From the aggregated accounts of enterprises supplied by national bodies, the European Commission has created a harmonised databank – BACH. Drawing on BACH, this study sets out to compare trends in the costs, profits or losses, and financial structures of enterprises in the Member States, the United States and Japan.

The national bodies responsible for centralising balance-sheet data supply the Commission with aggregated sectoral information. The Commission assumes that the samples used are representative as the data are published and analysed by those bodies.

To make comparative analyses possible, the basic accounts are harmonised according to a single layout consistent with the Fourth European Accounting Directive. This produces time series of accounting data by sector and size of enterprise, thus improving the comparability of balance-sheet structures and profit and loss accounts between countries. The BACH accounting layout was revised in 1995.

Harmonisation was at the centre of this revision, with comparability the main objective, sometimes to the detriment of detail. However, the specific nature of national accounting methods, together with the difficulty of compiling accounting documents a posteriori according to a common layout, restricted the degree of harmonisation of the data possible. Consequently, trend comparisons are possible, but comparisons of levels are trickier (and indeed impossible in some cases) and require a sound prior knowledge of each country's accounting and financial environment. DGII is a permanent associate member of the European Committee of Central Balance-Sheet Offices, which brings together national experts from the various bodies centralising balance-sheet information that supply data to BACH. The work of the European Committee of Central Balance Sheet Offices enables steady progress to be made in data harmonisation and its level of detail.

CONTENTS

• Countries:

The data bank currently covers 13 countries:
Austria (source: Österreichische Nationalbank)
Belgium (source: Banque Nationale de Belgique/Nationale Bank van België)
Denmark (source: Statistics Denmark)
Finland (source: Statistics Finland)²
France (source: Banque de France)
Germany (source: Deutsche Bundesbank)
Italy (source: Centrale dei Bilanci)
Japan (source: Ministry of Finance)
Netherlands (source: Centraal Bureau voor de Statistiek)
Portugal (source: Banco de Portugal)
Spain (source: Banco de Espana)

Sweden (source: Statistics Sweden)

United States (source: Department of Commerce)

• Years:

Chronological series are available which vary in length from one country to another.

The longest series begins in 1982 and the shortest in 1991.

• Sectors:

Data have been grouped together in an aggregate common nomenclature comprising 23 sectors or sub-sectors. This nomenclature is directly based on the new NACE to three digits.

• Size

A breakdown by size, based on a common criterion, is available. Four size categories are available: all sizes, small enterprises (turnover below EURO 7 million), medium-sized enterprises (turnover of between EURO 7 and 40 million) and large enterprises (turnover of more than EURO 40 million).

• Accounting data

The BACH accounting layout comprises a balance sheet and a profit and loss account presented in vertical and descending form, enabling not only basic items but also some financial balances considered particularly useful for financial analysis purposes to be shown. Additional data are given in an annex (investment flows, cumulative depreciation positions, etc.). These data will become more available depending on the country concerned.

USES³

For the user, data are always in a structured form, i.e. they are given as a percentage of the balance-sheet total in the case of the balance sheet and as a percentage of the turnover in the case of the profit and loss account. Any value comparison is impossible since the basic figures are expressed in national currency and taken from non-exhaustive samples

Some possible uses:

- comparative sectoral analyses
- sectoral reference systems
- performance comparisons between European, US and Japanese firms

² Finland is not included in the present analysis, due to lack of updated data.

³ For any further information, please phone to Mrs Savary (00.32.2.299.33.82) or to Mr Fons Marell (00.32.2.299.33.84).e-mail: maud.savary@dg2.cec.be

Box 2: Indicators of profitability

An enterprise is subject to various constraints: a profitability constraint if it is to survive and safeguard its development; a financial equilibrium constraint if it is to avoid liquidity crises and excessive dependence on banks.

Firms' performances are assessed using three indicators:

- Gross operating profit ratio (gross operating profit on net turnover):

The gross operating profit ratio is defined here as the gross operating surplus, which is the margin after paying the cost of materials and consumables, plus other operating charges and staff costs.

The gross operating profit enables the enterprise to create the necessary provisions to meet its financial charges and pay tax on its results.

- Net profit ratio (net profit on net turnover):

The net profit ratio corresponds to the final profit and loss for the financial year (as a percentage of turnover). It is

calculated by deducting sums set aside for provisions (value adjustments in respect of financial and non-financial assets), financial charges and the tax on the result from the gross operating profit. From an enterprise's viewpoint, the net profit ratio is particularly important since it is the final result, i.e. the enterprise's actual profit, which will be the source either of shareholder remuneration (dividends) or of self-financing through allocations to reserves. Evidently, an enterprise's investment potential is influenced by the evolution of its net profit ratio.

- Financial profitability (net profit on equity capital)

Financial profitability is obtained by dividing the net profit for the financial year by the enterprise's own funds. It gives an indication of the profitability of funds invested in the private sector for a majority shareholder. The net result is then either distributed in the form of dividends (which provide a return on the funds invested by the shareholder) or allocated to reserves and incorporated in own funds (which results in an increase in the value of the funds invested by the shareholder).

1. THE FINANCIAL SITUATION OF MANUFACTURING ENTERPRISES

1.1. The performance of European manufacturing firms appreciably improved in 1995, but more moderately than in 1994.

1.1.1. The performances of European manufacturing enterprises as measured by the gross operating profit ratio improved between 1994 and 1995.

In 1995, European companies' gross operating profit ratio improved from 9.7 % in 1994 to 10.2 % in 1995. Thus, companies' profitability levels attained 1987 levels, but remained 0.6 points lower than the record year 1988.

European companies' performances can be divided into three phases:

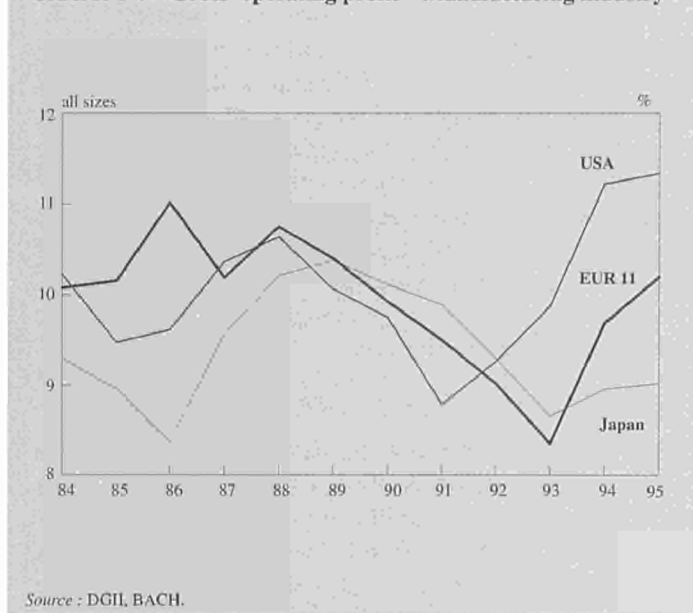
- between 1984 and 1988, an increasing trend⁴, easily explained by EU-wide economic expansion;
- after 1989, a strong trend reversal occurred, hitting bottom in 1993. This evolution mirrored the economic cycle, whose lowest point was also reached in 1993;
- since 1993, the trend has once again been reversed, returning to a high rate of growth of the gross operating profit ratio. This trend reflects the recovery observed in Europe since 1993. Between 1994 and 1995, the growth of European firms' profitability decelerated from 1.3 percentage points to 0.5 percentage points, in parallel with the evolution of industrial production. Industrial production decelerated from growth of 5.3% in 1994 to 3% in 1995.

⁴ A peak is reached in 1986 due to the excellent performances of United Kingdom.

TABLE 1 : Gross operating profit ratio

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
B	-	-	-	-	-	10.3	9.6	9.0	8.8	8.7	10.0	10.5	9.3	9.6
DK	9.0	8.6	8.1	7.8	8.8	8.9	8.4	9.2	9.9	10.2	10.4	-	8.9	9.1
D	-	-	-	8.2	8.8	8.4	8.6	8.2	7.4	5.6	7.2	7.8	7.9	7.8
E	10.9	10.4	10.9	11.0	12.1	11.2	9.2	8.5	6.4	4.9	8.8	10.3	9.4	9.3
F	9.0	9.6	10.7	11.3	12.1	11.4	10.5	10.5	9.8	9.0	9.7	9.5	10.5	10.5
I	10.0	9.8	10.6	10.5	10.6	9.9	9.0	8.6	8.5	8.5	9.1	10.1	9.5	9.5
NL	7.6	7.4	8.2	9.1	10.5	10.8	9.9	9.9	9.8	9.0	9.9	12.5	9.4	10.0
A	9.6	8.5	8.8	9.4	10.2	10.9	10.8	10.6	9.1	8.5	9.5	9.9	9.6	9.8
P	-	-	-	-	-	-	13.5	12.9	11.6	11.4	12.4	13.0	12.3	12.5
S	-	-	-	-	-	-	-	6.5	7.7	9.2	12.5	11.9	7.8	9.6
UK	11.7	12.3	13.3	12.7	13.0	13.4	12.8	12.6	12.7	13.1	14.3	14.4	12.9	13.2
EUR-11	10.1	10.2	11.0	10.2	10.8	10.4	9.9	9.5	9.0	8.4	9.7	10.2	9.9	9.9
JAP	9.3	9.0	8.4	9.6	10.2	10.4	10.1	9.9	9.3	8.7	9.0	9.0	9.5	9.4
USA	10.2	9.5	9.6	10.4	10.6	10.1	9.7	8.8	9.3	9.9	11.2	11.3	9.8	10.1

GRAPH 1 : Gross operating profit – Manufacturing industry



The most significant increases have been recorded in the Netherlands (+2.6 percentage points between 1994 and 1995), Spain (+1.5 percentage points between 1994 and 1995) and Italy (+1 percentage point between 1994 and 1995).

However, the causes of these positive evolutions differ to some extent in these three countries :

- In the Netherlands, firms' performances can be explained by the conjunction of two elements. Firstly, increased industrial production: compared with other European countries, the upturn began sooner than expected, (at the end of 1993) and remained at relatively high levels in 1994 (2.3%) and 1995 (2.1%). Secondly, the weight of purchases of goods and services and the weight⁵ of staff cost have decreased markedly.
- Italy and Spain show the same type of characteristics as the Netherlands: production remained at high levels in 1995, although with a slight deceleration in Spain, and moderate staff cost developments brought a positive contribution to margins. However, purchases of goods and services increased, contributing negatively to the margin. Furthermore, in these two countries, the impact of currency depreciation may have had a positive impact on margins. A study⁶ has shown that profit margins tended to increase in those countries whose currency depreciated over the period 1992–1995. Apparently, exporters in those countries preferred to increase their margins, so that there was an incomplete pass-through of currency fluctuations to export prices.

On the other hand, in two countries, the gross operating profit ratio decreased: in France (– 0.2 percentage points between 1994 and 1995) and Sweden (– 0.6 points between 1994 and 1995). In France, these results are due to declining value added in the car manufacturing sector.⁷

Between 1994 and 1995, the evolution of European companies' gross operating profit ratios was better than those recorded in Japan and the United States. In Japan, the gross operating profit ratio remained stable, while in the United States it only increased slightly (+0.1 percentage points between 1994 and 1995). Despite this favourable performance, the gross operating profit ratio in Europe remains below that observed in United States; however, it does now exceed Japan's.

The trend performances of American and Japanese enterprises also seem to mirror the business cycle:

- In the United States, the bottom of the business cycle was reached in 1991. The American economy then accelerated strongly and this is reflected by the evolution of the gross operating profit ratio, up continuously to 1995;
- In Japan, the gross operating margin decreased in parallel with the fall of industrial production up to 1991. After 1993, economic recovery permitted firms to improve profitability, but not at the same pace as European firms: from 1994, European firms' profitability has been slightly better than Japanese firms;

Comparing the evolution of the gross operating profit ratios of European, American and Japanese firms shows that:

- Over the period 1988–1992, there was a certain degree of convergence in enterprise performance amongst the Triad, although their economic cycles were unsynchronised;
- Since 1992, the gross operating profits ratios of European, American and Japanese firms have diverged. This growing gap increased considerably after 1993, peaking in 1995 with 2.3 percentage points separating Japan (the worst performances) from the United States (the best performances);

The increase of Europe's gross operating profit ratio in 1995 was mainly due to the conjunction of two elements: the growth of economic activity in manufacturing industry and cuts in staff costs offsetting the increase of purchases of goods and services:

-growth of economic activity in manufacturing industry

In 1995, industrial production increased 3%⁸ in volume terms in Europe, by 3.2% in the United States and 3.3% in Japan. However, in Europe and the United States, this increase was less marked than in 1994, when industrial production increased by 5.3% and 5.9% respectively. This growth pause explains why the growth of operating profit slowed in these two countries. By contrast, in Japan, firms have not fully benefited from reaccelerating growth of industrial production, up from 1.2% in 1994 to 3.3% in 1995.

⁵ For more details see following sections.

⁶ European Commission (1995), "The impact of exchange rate movements on trade within the single market", European Economy.

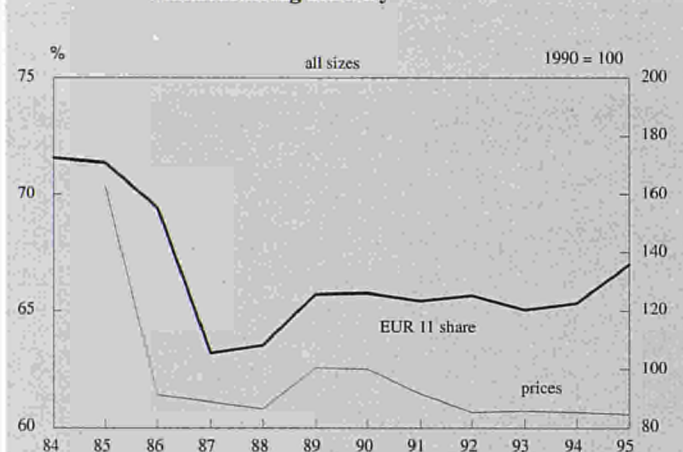
⁷ Source: "Situation du système productif en 1995", Banque de France.

⁸ Source: EUROSTAT and D.G.II, EC economic data pocket book, 6/1997.

TABLE 2 : Relative share of purchases of goods and services

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
B	-	-	-	-	-	76.0	75.8	75.8	75.1	74.5	74.3	74.7	75.4	75.2
DK	59.7	59.7	57.6	55.4	55.5	56.1	55.7	54.0	54.0	52.6	53.2	-	55.6	54.9
D	-	-	-	52.9	53.2	55.3	54.9	54.0	53.7	53.4	53.9	56.4	53.9	54.2
E	73.1	71.3	69.5	69.9	70.2	70.9	71.3	70.8	72.6	72.8	72.4	74.0	71.0	71.4
F	69.3	69.7	67.2	66.3	67.1	69.6	70.1	69.7	70.0	69.0	69.4	70.9	68.7	68.9
I	75.9	75.8	74.3	74.7	75.1	76.4	76.2	75.6	75.7	75.1	76.1	77.7	75.4	75.7
NL	76.1	76.5	74.3	72.1	71.5	72.2	72.8	71.9	72.0	72.7	73.1	71.9	72.9	72.4
A	52.0	49.9	49.3	52.2	51.0	51.9	52.4	52.3	52.3	53.8	54.4	56.4	51.7	52.6
P	-	-	-	-	-	-	69.9	69.3	69.1	67.9	68.8	70.2	69.0	69.2
S	-	-	-	-	-	-	-	71.7	75.8	71.3	70.6	71.2	72.9	72.1
UK	-	-	-	-	-	-	-	-	-	64.9	64.0	64.6	64.9	64.5
EUR-11	71.6	71.3	69.4	63.2	63.5	65.7	65.8	65.4	65.7	65.0	65.3	67.0	66.1	65.6
JAP	74.9	75.1	75.3	74.0	73.8	74.0	74.4	74.0	73.6	73.5	73.3	73.7	74.2	74.0
USA	-	-	-	-	-	-	-	-	-	-	-	-	-	-

GRAPH 2 : Relative share of purchases of goods and services and primary commodity prices (ECU) – Manufacturing industry



Source : DGII, BACH.

-sustained increase of purchases of goods and services

For European countries, the weight of purchased goods and services relative to turnover increased by 1.7 percentage points from 65.3% in 1994 to 67% in 1995. This increase followed five years of relative stability and was most acute in certain countries: Germany, Austria, Italy, Spain and France. The evolution cannot be explained by the primary commodity prices⁹, which has been stable since 1992, expressed in ECUs.

1995's evolution in the proportion of purchases of goods and services to turnover differed widely from country to country as:

- some countries managed to reduce the proportion of purchases of goods and services (p.g.s.) in turnover despite the expansion of their industrial production: Portugal, (p.g.s.: -1.4 percentage points between 1994 and 1995, industrial production: +4.6% in 1995) and the Netherlands (p.g.s.: -1.4 percentage points between 1994 and 1995, industrial production: +2.3%);
- other countries recorded a augmentation of the p.g.s. between 1994 and 1995: Germany (+2.5 percentage points), Austria (+2 percentage points), Spain (+1.6 percentage points), France (+1.5 percentage points), Italy (+1.6 percentage points), Sweden (+0.6 percentage points), United Kingdom (+0.6 percentage points) and Belgium (+0.4 percentage points).

-the weight of staff costs continued to decrease

1995 saw a significant decline in the weight of European enterprises' staff costs. The fall between 1994 and 1995 reached 1 percentage point, down from 21% to 20% of turnover. In 1995, the level of staff costs was 1.4 percentage points under the 1985-1993 average. The decrease was even more marked as a percentage of value added, down from 68.2% in 1994 to 65.7% in 1995.

⁹ Source: DG II and Eurostat, all commodities.

Box 3: Purchases of goods and services

The proportion of purchases of goods and services in relation to turnover differs appreciably from one European country to another. Two groups of countries can be distinguished:

- countries where the proportion is very high, over 70% of turnover: Belgium, Spain, Italy, Netherlands, Portugal, Sweden.

- countries where the proportion is lower: Austria, Denmark, Germany, UK.

The discrepancy between these two groups of countries is due to various reasons, in particular, specialisation by industry in sectors that are raw-material intensive to differing degrees and varying degrees of subcontracting. Analysis of this item is therefore more relevant in trends.

[illegible]

Box 5 : Financial charges

An enterprise's financial charges essentially constitute interest paid on loans. For some countries the concept of financial charges used here (for reasons inherent in the technical problems of international comparability) is broader than the traditional concept of "interest paid". In certain countries in particular, it includes negative foreign-

exchange differences (such differences represent varying proportions of financial charges depending on the country in question and range from 5% to 15%). Financial charges may also include sums repaid to the group and to associated enterprises.

TABLE 5 : Net profit ratio

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
B	-	-	-	-	-	3.6	2.2	1.0	0.6	0.1	2.2	2.3	1.5	1.7
DK	4.8	3.7	2.7	2.6	3.5	4.0	3.8	3.5	3.9	3.8	4.4	-	3.5	3.6
D	-	-	-	1.8	2.1	2.1	1.8	1.6	0.9	0.5	1.2	1.8	1.5	1.5
E	-2.1	-0.7	1.0	3.0	4.6	4.7	2.3	-0.1	-3.2	-5.8	0.3	1.0	0.6	0.8
F	-1.3	0.5	1.2	2.8	3.6	3.6	2.7	1.9	1.3	0.2	2.3	2.3	2.0	2.2
I	0.3	0.6	1.4	1.9	1.3	1.6	1.2	0.2	-1.7	-2.1	0.2	1.8	0.5	0.6
NL	4.4	3.6	4.0	5.3	6.9	8.4	6.5	7.3	6.1	5.6	7.4	9.1	5.9	6.6
A	2.5	1.1	1.8	2.1	3.0	3.4	3.0	3.4	1.7	0.8	2.7	3.2	2.2	2.5
P	-	-	-	-	-	-	3.4	1.6	0.1	-0.4	1.3	2.5	1.2	1.4
S	-	-	-	-	-	-	-	3.6	1.5	3.4	11.5	7.6	2.8	5.5
UK	5.0	5.0	5.8	7.0	7.7	7.7	6.3	5.5	5.0	6.0	6.5	7.3	6.2	6.5
EUR-11	1.2	1.8	2.6	3.1	3.5	3.7	2.9	2.2	1.1	0.8	2.7	3.2	2.4	2.6
JAP	1.7	1.5	1.2	1.7	2.2	2.3	2.2	1.7	1.0	0.6	0.8	1.3	1.6	1.5
USA	4.5	3.7	3.7	4.9	5.7	4.7	3.8	2.3	0.8	2.6	5.4	5.8	3.6	4.0

TABLE 6 : Share of financial charges in turnover

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
EUR Manufacturing Industries	2.8	1.9	1.8	2.1	2.4	2.6	2.8	2.8	2.1	2.0

The rise of the net profit ratio occurred in all member states. The most significant increases were achieved in the Netherlands (+1.7 percentage points), Italy (+1.6 percentage points) and Portugal (+1.2 percentage points). The feeblest performances were realised by France and Belgium (+0.1 percentage points).

Note the similar increase of the net profit ratio and the gross profit ratio in Europe, both up 0.5 percentage points between 1994 and 1995. This differed appreciably from the previous year: the gross operating profit increased by 1.3 percentage points in 1994, whilst the net profit ratio increased by 1.9 percentage points. This was caused by the fall of financial charges, which particularly boosted the net profit ratio. In 1994 and 1995, conversely, the weight of financial charges was rather flat in European countries (2% in both years), so that it was neutral on the evolution of the net profit ratio.

For the first time since 1992, financial charges have not contributed to the improvement of net profitability. The decreasing trend observed since 1992 paused. How can the flat evolution of financial charges be explained? Financial charges depend roughly on two factors. Firstly, the amount of indebtedness carried by firms, and secondly, the level of interest rates paid by firms on this indebtedness. As almost 77% of debt carried by European firms is short term debt, it's likely that firms are more sensitive to the evolution of short term interest rates.

- evolution of interest rates: in Europe, after a marked decrease of short-term interest rates in the previous three years, this trend paused during the first months of 1995. On average, short term interest rates even increased from 6.5% in 1994 to 6.7% in 1995. However, the impact of this increase on European firms is hardly not perceptible. The apparent rate of interest paid, which relates financial charges to balance-sheet debt paid by firms¹¹, decreased slightly by 0.2 percentage points, from 8.2% in 1994 to 8.0% in 1995. Firms may have benefited from the relaxation of interest rates in the second part of the year.

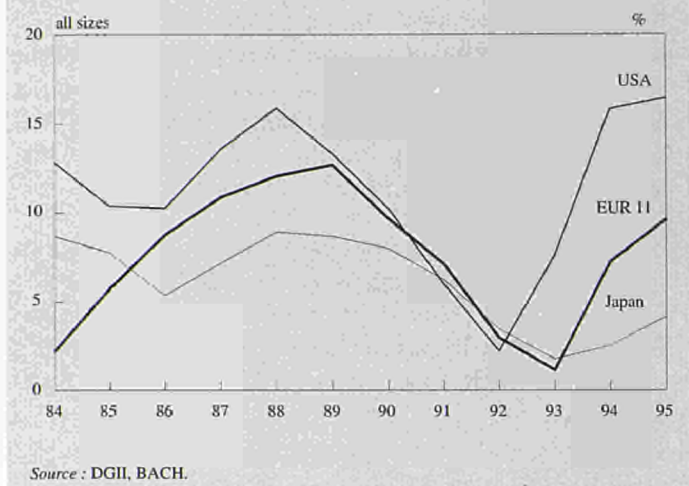
- evolution of indebtedness: as explained in the following sections, the share of indebtedness has decreased for European firms in 1995.

1.1.3. European enterprises managed to improve their financial profitability.

European enterprises' financial profitability, observed since 1993, continued to improve in 1995: up from 7.2% to 9.6%. However, the pace of improvement slowed: European firms'

¹¹ However, the debt at the balance-sheet date may differ widely from average debt over the financial year.

GRAPH 6 : Financial profitability – Manufacturing industry



financial profitability increased by 6 percentage points between 1993 and 1994, but by only 2.4 in 1995. Moreover, 1995 data remains below the peaks recorded in 1988 and 1989, the highest points of the series so far.

The improvement of European financial profitability has, over the past two years, exceeded that of the United States: the profitability of American enterprises rose from 15.8% to 16.4%, an increase of only 0.6 percentage points. However, American firms have reached their highest level of financial profitability since 1984, well above their average level (9.9%). So, despite the clear improvement of European firms' financial profitability, the gap with American firms remains important and has even increased since the beginning of the period under review. In Japan, the profitability ratio rose from 2.5% to 4.2%, but the ratio is still below the 1985–1993 average (6.4%). Japanese firms' performances in term of financial profitability are the lowest of the Triad, which can be explained by the weakness of the net profit ratio in the recent period.

The evolution of European firms' financial profitability is contrasted over the last ten years. After declining sharply dur-

ing the early 1980s, the return on capital improved considerably during the strong economic 1986–90 upturn. In 1992/93, as the Community economy slid back into recession, financial profitability dropped, going back to its 1984 level. Even if the strong improvement of financial profitability after 1993 failed to recapture the high levels reached in 1988/89, **sound profitability ratios have positive effects on the economy: they are likely to sustain increased investment, not only by raising expected returns on capital but also by exerting a beneficial impact on the balance sheet position and thus the financing capabilities of companies.**

In Europe, this recovery occurred in all Member States. The most spectacular improvement was achieved by Italy, whose profitability ratio increased from 0.6% to 7.6% (+7 percentage points). Significant improvement also occurred in Netherlands (+4.7 percentage points) and Portugal (+2.8 percentage points). The financial profitability ratio increased less than the European average in the United Kingdom (+2.6 percentage points), Spain (+2.2 percentage points), Austria (+1.6 percentage points) and Germany (+2.3 percentage points). The poorest performances were recorded by Belgium and France (+0.4 percentage points).

1.1.4. For the first time since 1990, European firms' financial profitability in 1995 exceeded the nominal long term interest rate.

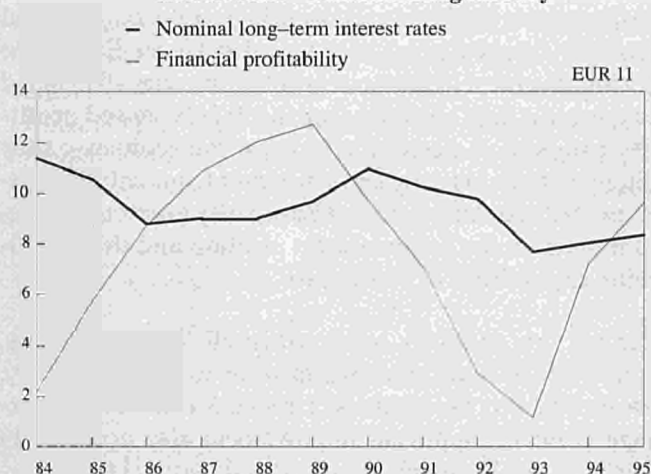
In 1995, the financial profitability of European enterprises (9.6%) exceeded the nominal long-term interest rate¹² (8.4%), by 1.2 percentage points. This result is very important: a shareholder arbitrating between government bonds and equity in a company compares the respective output of these two investments. He may prefer to place his capital in the company only if the output offered is higher than the investments in government bonds, risk-premium included. This premium corresponds in particular to various factors such as the risk of illiquidity or uncertainty about the future results of the company.

¹² Yield on benchmark 10-year bond

TABLE 7 : Financial profitability

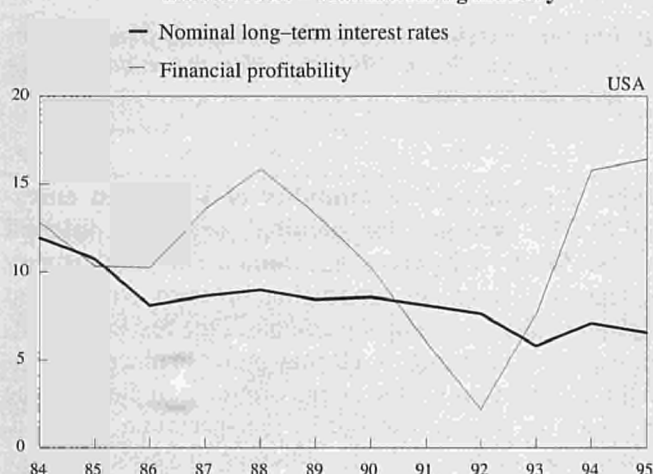
	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85–93	86–95
B	–	–	–	–	–	11.0	6.5	2.8	1.8	0.4	5.9	6.3	4.5	5.0
DK	19.1	14.3	10.7	9.6	12.3	14.0	13.2	11.7	12.4	11.5	13.0	–	12.2	12.0
D	–	–	–	8.0	9.5	10.2	8.8	7.6	4.2	1.9	5.0	7.3	7.2	6.9
E	–6.6	–2.1	2.8	8.3	11.7	12.0	5.8	–0.1	–9.0	–17.0	0.8	3.0	1.4	1.8
F	–10.1	3.0	6.6	13.2	15.4	14.8	10.8	7.2	4.6	0.7	7.4	7.8	8.5	8.9
I	1.3	2.7	5.8	7.5	5.5	6.9	4.5	0.6	–6.6	–8.6	0.6	7.6	2.0	2.4
NL	12.3	10.1	10.3	12.3	15.4	18.2	13.4	13.4	11.1	9.2	11.8	16.5	12.6	13.2
A	15.3	6.7	11.1	11.5	16.3	19.0	14.9	14.6	6.5	2.9	9.7	11.3	11.5	11.8
P	–	–	–	–	–	–	8.0	3.9	0.3	–0.8	2.9	5.7	2.8	3.3
S	–	–	–	–	–	–	–	10.6	4.0	8.8	25.9	18.3	7.8	13.5
UK	13.4	13.3	15.8	18.3	19.3	20.2	16.5	13.4	11.6	14.2	15.1	17.7	15.9	16.2
EUR-11	2.2	5.7	8.7	10.9	12.0	12.7	9.7	7.1	2.9	1.2	7.2	9.6	7.9	8.2
JAP	8.7	7.7	5.3	7.2	8.9	8.7	8.0	6.2	3.5	1.8	2.5	4.2	6.4	5.6
USA	12.8	10.4	10.3	13.6	15.9	13.3	10.3	6.0	2.2	7.6	15.8	16.4	9.9	11.1

GRAPH 7 : Financial profitability and nominal long-term interest rates – Manufacturing industry



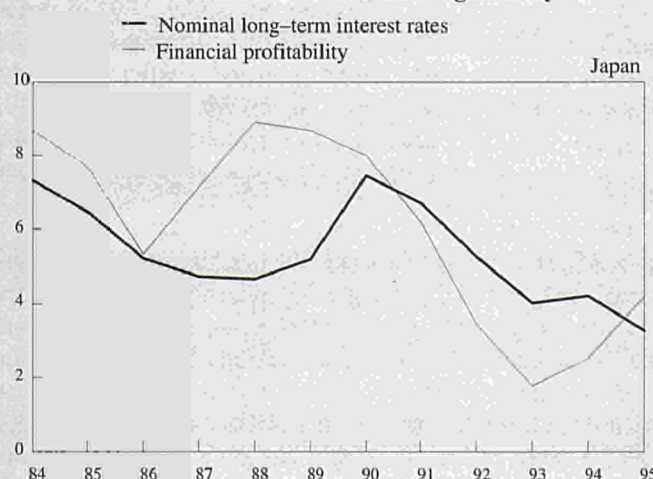
Source : DGII, BACH.

GRAPH 8 : Financial profitability and nominal long-term interest rates – Manufacturing industry



Source : DGII, BACH.

GRAPH 9 : Financial profitability and nominal long-term interest rates – Manufacturing industry



Source : DGII, BACH.

This situation has not occurred since 1990 for European enterprises:

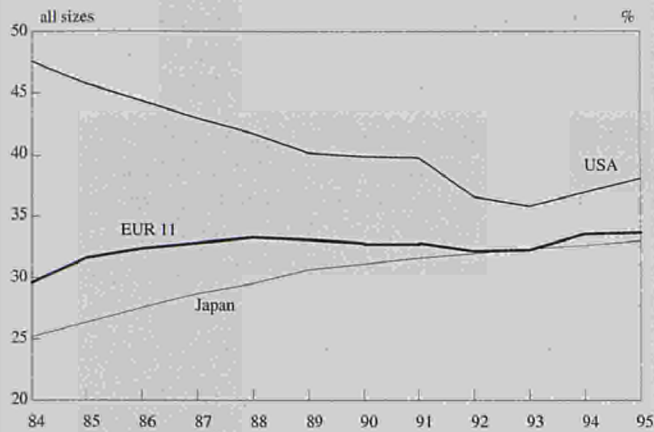
- between 1984 and 1986, nominal long term interest rates were higher than financial profitability. In fact, the level of financial profitability was very low at the beginning of the 1980s. Although European enterprises significantly improved their financial profitability from 1984 to 1986, the level remained below the long term interest rate.
- between 1986 and 1989, the level of the nominal long term interest rate was still high (8.9% in 1986, 9.1% in 1987, 9.1% in 1988, 9.7% in 1989, 10.9% in 1990) but the gap became positive. In fact, the level of financial profitability reached its highest levels in 1988 (12%) and 1989 (12.7%);
- from 1989 to 1993, financial profitability fell. Although the nominal long term interest rate also decreased, the difference between nominal interest rates and financial profitability still became negative again.

In 1995, three groups of countries can be distinguished within Europe:

- countries where the financial profitability ratio was significantly above nominal long-term interest rates: the United Kingdom, the Netherlands (a positive difference of 9.3 percentage points for the Netherlands and of 9.4 percentage points for the United Kingdom) and Austria (positive difference of 4.2 percentage points). The conjunction of low long term interest rates and high levels of profitability explains these good results;
- countries where the financial profitability ratios were very close to the nominal long term interest rate in the public sector (positive difference of +0.3 in France, +0.8 in Germany). In these two countries, firms' financial profitability generally remains under the European average (respectively 1.5 and 2 percentage points), but the level of long term interest rates also rank amongst the lowest in Europe;
- countries where the gap between financial profitability and nominal interest rates remained negative: Belgium (-0.8 percentage points), Italy (-0.7 percentage points), Portugal (-4.6 percentage points) and Spain (-8 percentage points). Belgium was affected by the weakness of its firms' financial profitability, still 3 percentage points below the European average. In Italy and Portugal, the gap resulted from the conjunction of weak financial profitability and high levels of interest rate, due to a combination of high public deficit, persistent high inflation and currency weakness in 1995.

Something similar can be observed in Japan. Japanese firms' financial profitability also exceeded nominal long term interest rates for the first time since 1991. Relaxation of interest rates and increased financial profitability lie behind this. In the United States, the picture has been radically different. Apart from 1991, firms' financial profitability has continuously exceeded nominal long-term interest rates. This is because, firstly, long term US interest have consistently been below Europe's. Secondly, the profitability of American firms has been better, especially in the four years up to 1995.

GRAPH 10 : Own funds ratio – Manufacturing industry



Source : DGII, BACH.

1.2. Thanks to their performances, European enterprises managed to improve their financial structures.

1.2.1. The proportion of own funds for European firms has increased.

In 1995, the own funds ratio of European enterprises stabilised at 33.6%, a 10 year peak and 1 percentage point over the 1985–1993 average, but less than the increase in the United States or Japan. 1995 saw a very marked pick-up in the own funds ratio of American enterprises, from 37% to 38.1%. Nevertheless, this value remains below the average of the past ten years (40.8%). In Japan, the own funds ratio rose from 32.7% to 33%.

The past decade has seen a diverging evolution of the own funds ratio between, on the one hand, the United States and, on the other hand, Europe and Japan. In the United States, the

ratio has strongly declined from 43% in 1987 to 38.1% in 1995. By contrast, it has increased in Japan and to a lesser extent in Europe. In Japan, the increase was from 28.7% in 1987 to 33% in 1995; in Europe, the increase was from 32.8% in 1987 to 33.6% in 1995. These different evolutions led to relative convergence inside the triad: in 1995, the proportion of own funds in the balance sheet has become similar in Europe (33.7%), Japan (33%) and the United States (38.1%). At the beginning of the period, the gap between the lowest value (i.e. Japan with 25.2% in 1984) and the highest value (United States with 47.6%) was 18.5 percentage points. In 1995, it was only 5.1 percentage points.

The main differences observed at the beginning of the period reflected the different organisations of capital markets. In the United States and, to a certain extent, the UK, financing of firms is directly based on financial markets. Self-financing and financing through equities are highly developed. Conversely, in continental Europe and Japan, firm financing is based more on the banking system, and characterised by weaker self financing, more bank indebtedness and less bond financing. Of course, this general picture conceals country differences. In Germany, for instance, firms rely more on self-financing. Banks control all other financing, i.e. external financing and equity increases.

No direct link can be made between the evolution of margins within the Triad and the proportion of own funds. In Europe and Japan, the cyclical evolution of margins (c.f. section 1.1) are not reflected in the evolution of own funds, which have continuously increased. In the United States, however, the slight increase in the own funds ratio within the past three years may be linked to the marked improvement of margins since 1993. However, this explanation is contradicted by the 1986/1989 episode, when American firms' profits were very high, yet the own funds ratio steadily decreased. The share of own funds does not seem easily explained by the level of margins but by external factors, including variations in taxation, bankruptcy regulations, organisation of the banking system, the relationship between banks and companies and the financing practices of each country.

TABLE 8 : Own funds ratio

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85–93	86–95
B	–	–	–	–	–	42.0	40.6	39.2	38.2	37.9	39.4	39.4	39.6	39.5
DK	36.2	35.7	34.8	34.6	35.1	35.5	35.6	36.7	38.0	39.4	40.4	–	36.2	36.7
D	–	–	–	30.2	30.1	29.3	29.6	30.1	29.7	30.2	30.7	31.9	29.9	30.2
E	29.2	32.4	35.7	38.5	43.0	44.7	42.4	39.2	36.4	32.8	35.4	39.3	38.4	38.8
F	15.9	20.6	23.1	26.9	30.2	32.3	32.2	33.7	34.5	34.6	36.6	35.7	29.8	32.0
I	25.9	26.6	28.5	28.6	26.9	27.1	27.8	28.0	25.6	25.4	25.7	25.8	27.1	26.9
NL	43.4	43.3	45.0	45.7	46.2	45.7	44.6	45.1	44.5	46.9	49.7	47.8	45.2	46.1
A	18.8	19.1	19.9	21.4	22.2	22.2	23.4	26.1	29.0	29.6	30.2	31.3	23.7	25.5
P	–	–	–	–	–	–	42.5	41.4	41.3	42.8	43.1	44.2	42.0	42.6
S	–	–	–	–	–	–	–	25.4	26.0	26.7	33.9	33.5	26.0	29.1
UK	46.7	47.6	44.1	45.4	44.9	39.8	37.4	37.7	36.7	37.0	37.8	36.1	41.2	39.7
EUR-11	29.7	31.6	32.3	32.8	33.3	33.1	32.8	32.9	32.2	32.3	33.6	33.6	32.6	32.9
JAP	25.2	26.4	27.6	28.7	29.5	30.7	31.1	31.6	32.0	32.4	32.7	33.0	30.0	30.9
USA	47.6	45.8	44.4	43.0	41.8	40.2	39.8	39.8	36.6	35.8	37.0	38.1	40.8	39.6

Box 6 : Own funds

Own funds are important for the sound development of an enterprise. An adequate level of own funds and favourable profit prospects encourage investment. New and innovative enterprises, especially whose exposure to risk is higher owing to weaker self financing capacity at start up, find an insufficient initial level of own funds to be a major obstacle to investment. Consequently, structural changes required by technological innovation can be impeded, and the long term growth potential of an economy consequently undermined.

Own funds are also a key measure of individual enterprise performance. The own funds ratio indicates an enterprise's financial solidity and hence its solvency, and reveals to what extent an enterprise's shareholders underwrite its risks. The prime function of own funds is to underwrite risk and therefore to reduce the danger of insolvency for external lenders of funds. An enterprise's borrowing capacity depends directly on the level of its own funds. A firm relying too much on debt risks increased interest rates, which can jeopardise its future development and even survival.

Own funds are made up of share capital, share issue premiums, revaluation reserves, reserves, accumulated profits and operating profits for the year. Operating profits are shown before allocation in most cases. The ratio used here makes it possible to measure own funds, net of the proportion of profits to be paid to shareholders, in relation to total

assets. Total assets can be affected by the customary means of financing an enterprise's current activities. Substantial use of the payment period granted by suppliers can alter total short term debts and therefore total liabilities.

Furthermore, despite the harmonisation resulting from the fourth company law Directive, different countries show own funds differently. National legislation and financing customs may also impact on the level of own funds. This reduces the comparability of levels of own funds across countries.

The question of the adequate level of own funds has been widely discussed¹³. A financial strategy therefore corresponds to each industrial strategy, whether for internal or external growth. This financial strategy reflects the method of financing adopted, i.e. the choice between self-financing, recourse to borrowing or a call on shareholders. In theory, there are many possible compromises between these various sources of finance, even though, for a certain number of firms, the constraints, which are notably of an institutional nature, greatly reduce the range of choice. For example, small and medium-sized companies often find it hard to obtain access to capital markets.

¹³ CF "fonds propres des entreprises industrielles en Europe sur la période 1991-1993", bulletin de la Banque de France, Mai 1997.

The increase in the own funds ratio occurred in most European countries, except the United Kingdom (down 1.7 percentage points), France (-0.9 percentage points), and the Netherlands (-1.9 percentage points). The most significant improvements were recorded by Spain (+3.9 percentage points), Germany (+1.2 percentage point), Austria (+1.1 percentage points) and Portugal (+1.1 percentage points). The weakest improvements were recorded by Italy (+0.1 percentage points) and Belgium (same result as for 1994). Analysis of the own fund ratio over the last decade shows an increasing trend in most European countries, especially France (from 15.9% in 1984 to 35.7% in 1996) and Austria (from 18.8% in 1984 to 31.3% in 1995). The United Kingdom is a notable exception: the proportion of own funds in the balance-sheet total decreased from 46.7% in 1984 to 36.1% in 1995.

1.2.2. Analysis of indebtedness

In both Europe and the United States, the decrease of the overall indebtedness ratio continued in 1995.

The figures show a similar evolution of the ratios in Europe and the United States:

- In Europe and the United States, the overall indebtedness ratio decreased between 1994 and 1995 : in Europe from 50.2% to 49.5% and in the United States, from 55.1% to 54.2%;
- In Japan, the overall debt structure ratio remained flat between 1994 and 1995 at 62%, but well above the ratio in United States and Europe;

TABLE 9 : Overall debt ratio

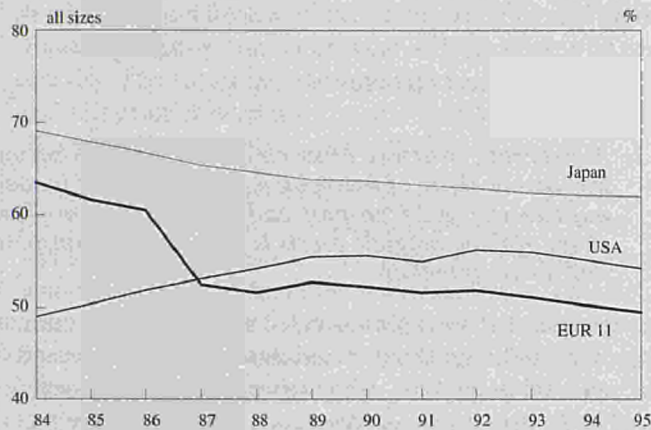
	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
B	-	-	-	-	-	53.2	54.4	55.9	56.9	56.9	55.6	55.2	55.5	55.4
DK	59.5	59.5	60.0	60.0	59.4	59.3	59.6	58.7	57.4	56.0	55.0	-	58.9	58.4
D	-	-	-	38.1	37.5	38.9	38.8	38.6	38.4	37.4	36.8	34.4	38.2	37.6
E	67.5	63.6	60.2	57.3	52.5	51.1	52.7	55.9	58.5	61.3	59.0	54.7	57.0	56.3
F	77.7	73.6	71.0	67.5	64.4	62.6	62.6	60.7	59.1	59.1	57.5	58.4	64.5	62.3
I	65.0	64.3	62.6	62.7	63.7	64.2	63.6	63.2	65.7	65.7	65.6	65.5	64.0	64.3
NL	49.2	49.4	47.7	47.1	47.4	48.2	49.4	49.5	50.2	47.8	45.4	45.7	48.5	47.8
A	63.0	60.4	59.4	59.2	58.4	59.5	58.3	55.0	52.1	53.4	53.4	52.1	57.3	56.1
P	-	-	-	-	-	-	52.1	52.4	52.1	51.0	50.7	49.3	51.9	51.3
S	-	-	-	-	-	-	-	50.0	51.4	52.0	45.6	46.3	51.2	49.1
UK	49.0	48.2	50.7	48.4	49.0	54.5	50.8	49.0	48.6	45.3	46.0	47.3	49.4	49.0
EUR-11	63.5	61.6	60.5	52.4	51.6	52.8	52.2	51.5	51.8	51.1	50.2	49.5	53.9	52.4
JAP	69.2	67.8	66.8	65.3	64.7	63.9	63.7	63.2	62.8	62.3	62.1	62.0	64.5	63.7
USA	49.0	50.3	51.8	53.0	54.2	55.4	55.5	55.0	56.2	56.0	55.1	54.2	54.2	54.6

Box 7: Overall indebtedness

The concept of debt used here is the overall indebtedness ratio, which reflects the proportion of debt in the balance sheet. All debt is taken into consideration, i.e. not only bank

debt, which accounts for the bulk of total debt, but also bond issue, commercial, tax and social security debts, any intra-group debt, etc.

GRAPH 11 : Overall debt ratio – Manufacturing industry



Source : DGII, BACH.

The fall of Europe's overall indebtedness ratio may be because:

- The slowdown in growth in the beginning of the 90s resulted in a climate unfavourable to investments;
- The cost of credit has been too high compared to the profitability of foreseen investments. However, in a context of decreasing interest rates, this explanation does not seem applicable to Europe;
- Enterprises' profits are high enough to self-finance their projects. Given the high profit levels achieved in 1994 and 1995 (c.f. section 1.1) and the low level of investment, this is a more plausible hypothesis.

The decrease of the overall indebtedness ratio occurred in most European countries, except for the United Kingdom (+ 1.3 percentage points), France (+0.9 percentage points), the Netherlands (+0.3 percentage points) and Sweden (+0.7 percentage points). The share of own funds in the balance sheet also decreased in those countries.

Analysis over a longer period shows quite a varied evolution before 1992 with declines in Europe and Japan and an increase in the United States. **After 1992, overall debt ratios within the Triad decreased at the same pace:**

- Over the last decade, European firms¹⁴ and Japanese firms have had quite similar evolution. They managed to reduce their indebtedness.
- By contrast, the overall debt ratio of US enterprises increased appreciably until 1993, from 51.8% in 1986 to

56.2% in 1993. After that, the ratio decreased from 56% to 54.2% in 1995.

European firms rely mostly on short term credits and the share of short term debt continues to increase.

There is a wide contrast between, on one hand, the structure of debt in Europe and Japan and, on the other, the United States:

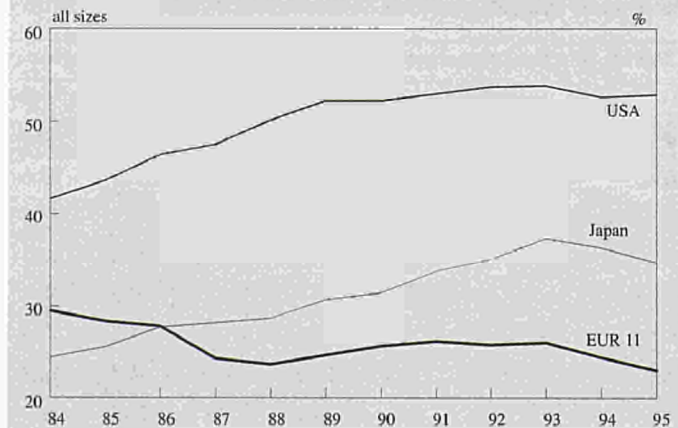
- In Europe, short term debt seems to be a common way of financing firms: the proportion of debt in excess of one year represents only 23% of total debts in 1995. However, this general picture conceals a number of differences amongst European countries. Two groups of countries can be distinguished:

countries, which rely less than average on short term debt in 1995: Austria (29.3% in 1995), Denmark (30.6% in 1994), Belgium (35.4%), the United Kingdom (30.2%), France (29.6%), Netherlands (37.3%), Portugal (31.3%) and Sweden (34.1%);

countries which rely more than average on short term debt for their external financing: Germany (13.9%), Spain (20%), Italy (16.7%).

- In Japan, the ratio of debt in excess of one year to total debts is 34.7% in 1995, showing a clear preference for short term financing;
- In the United States, the proportions are reversed. The over 50% share of long term financing to total debt shows a preference for long-term financing.

GRAPH 12 : Debt structure – Manufacturing industry
(ratio of debt with a remaining period to maturity of more than one year to total debt)



Source : DGII, BACH.

¹⁴ In Europe, there was a strong decrease in 1986/87 due to inclusion of Germany in the statistical series. German firms are characterised by a low level of indebtedness, which is linked to the important amount of provisions for liabilities and charges in total financing.

Box 8: Debt structure

By studying the composition and nature of indebtedness by debt maturity, it is possible, in theory, to evaluate part of the financial constraints borne by enterprises. Long term debt (more than one year), traditionally more stable and less ex-

pensive, reflects the degree of confidence placed in enterprises by the banking system. However, it is awkward to make international comparisons in this area because of the differences in behaviour and customs within each country.

In 1995, the share of long term debt continued to decrease in Europe and Japan. In Europe, the decrease was from 24.2% in 1994 to 23%, a decrease of 1.2 percentage points. In Japan, the decrease was slightly more marked as the ratio decreased by 1.6 percentage points, from 36.3% to 34.7%. By contrast, the ratio remained quite stable for the United States at 52.8%.

Over the past ten years, however, the picture is quite different. The share of long term financing has increased for Japanese and American firms, whilst European firms in recent years have used relatively more short term financing:

- In Europe, the share of long term debt has decreased, from 26.2% in 1991 to 23% in 1995.
- In the United States, the ratio has increased from 41.6% in 1984 to 52.8% in 1995. This same trend can be observed in Japan, where the ratio has increased from 24.5% in 1984 to 34.7% in 1995.

2. SECTORAL ANALYSIS

In this part we expand the analysis of the previous part to sectors other than manufacturing. The objective here is, however, somewhat different from part 1. Rather than commenting on recent developments, differences in balance sheet structures are the focus, to establish sectoral links between balance sheet structures and performances. Four additional sectors are considered here: building and civil engineering, trade, transport and communication and other services. This disaggregation is relatively broad but imposed by data availability. The analyses cover the period 1986–95. As manufacturing has been dealt with in the previous section, developments and trends in that sector will not be analysed in this part. Nonetheless, it is included for comparison.

The first section gives a general picture of the composition of balance sheets in the different sectors at the European level. The second section presents an overview of costs and profit-

ability. Finally, the last section attempts to establish a link between sectoral balance sheet structures and profitability in Europe.

2.1. Balance sheet structures

2.1.1. A diverging structure of assets across sectors with an increasing share of financial assets, especially in manufacturing and transport and communication. The share of fixed tangible assets is very high in transport and communication.

The assets of a firm can be divided into fixed and current assets. Generally speaking, fixed assets reflect the capital stock invested in the firm, while current assets are assets included in the production process, such as stocks and raw materials. The nature of activity in each sector is reflected by its composition of assets. Fixed assets cover intangible assets (licences, patents, software, goodwill, etc.), tangible assets (buildings, machines etc.) and financial assets (shares in other firms etc.)¹⁵. The composition of assets is presented in Table 11.

At one extreme, fixed assets in the transport and communications sector covered, on average over the period 1986–95, 72.2% of the balance sheet, of which a substantial part was tangible assets. At the other extreme, the building and civil engineering sector had 27 % of fixed assets with only 16.5 % in tangible assets. The composition of assets is somewhat similar in manufacturing, trade and other services, even though the shares of financial assets and intangible assets in the other services sector was larger than in trade and manufacturing. The share of fixed assets has been increasing significantly in manufacturing, trade and transport and communication.

¹⁵ The composition of assets is of course sensitive not only to the activities undertaken but also the way in which they are accounted for. For instance, if a firm chooses to lease machines instead of buying them, this will affect the composition of assets.

TABLE 10 : Debt structure – (debt with a maturity over one year relative to total debt)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85–93	86–95
B	–	–	–	–	–	30.4	34.0	34.3	35.1	36.1	35.0	35.4	34.0	34.3
DK	26.3	27.8	29.7	30.5	30.4	28.6	29.8	29.5	29.6	30.8	30.6	–	29.6	30.0
D	–	–	–	19.9	19.1	18.1	17.6	17.3	16.4	17.9	16.5	13.9	18.0	17.4
E	31.0	27.8	28.1	25.7	25.7	22.8	21.6	23.1	25.2	24.3	21.5	20.0	24.9	23.8
F	34.5	33.7	32.2	30.7	29.2	32.2	34.2	33.8	33.9	34.6	31.2	29.6	32.7	32.2
I	21.7	21.2	20.6	19.4	17.9	17.8	18.9	19.0	18.8	17.0	16.4	16.7	18.9	18.2
NL	33.2	30.8	32.5	34.2	34.9	32.8	38.0	36.8	36.0	39.0	37.4	37.3	35.0	35.9
A	31.3	29.5	31.2	29.1	29.1	28.7	26.5	27.0	28.5	30.2	30.6	29.3	28.9	29.0
P	–	–	–	–	–	–	32.4	31.4	30.1	33.9	31.4	31.3	32.0	31.8
S	–	–	–	–	–	–	–	40.0	39.6	40.4	39.9	34.1	40.0	38.8
UK	31.5	30.2	29.4	27.0	28.2	33.3	35.3	35.8	34.1	32.4	30.6	30.2	31.7	31.6
EUR-15	29.5	28.3	27.8	24.3	23.7	24.7	25.7	26.2	25.9	26.0	24.4	23.0	25.8	25.2
JAP	24.5	25.5	27.7	28.2	28.6	30.7	31.5	33.8	35.1	37.3	36.3	34.7	30.9	32.4
USA	41.6	43.6	46.3	47.5	50.1	52.2	52.2	53.0	53.8	53.9	52.7	52.8	50.3	51.5

Box 9: Sectoral breakdown¹⁶ and construction of the European average

1. Sectoral breakdown

The **building and civil engineering** sector (NACE 45) accounts for approximately 9,2 % of European employment. Employment in the sector traditionally varies according to the business cycle but with a general downward trend related to increasing productivity gains and increased off-site assembly of components in the sector. Building and civil engineering mainly consist of local activity with little export activity. The sector depends strongly on domestic demand, including public demand. The share of SMEs in salaried employment is very high in this sector (84 % in 1992)¹⁷.

The **trade** sector (NACE 50.1 + 50.3 + 50.4 + 51 + (52.1–52.6) + 50.5 + 55) represents about 27 % of employment in the European Union. It covers activities such as wholesale, retail trade, hotels and restaurants. The sector is currently undergoing structural changes driven by increased concentration, diversification and internationalisation. Increasing integration within the internal market also characterises the sector, a process likely to be further encouraged by introduction of the single currency. Electronic commerce will be a future challenge. The share of SMEs in salaried employment in the sector is very high (81 % in 1992).

The **transport and communications** sector (NACE 60–64) covers very diversified activities such as land, water and air transport, post and telecommunications. It accounts for over 5,3% of total employment in Europe, and faces challenges from liberalisation, privatisations and increasing competition. Mergers and alliances are typical in the sector. It needs to undertake large investment and restructuring programmes in order to adapt to new technologies and new service concepts. The share of SMEs in salaried employment is low (46 % in 1992).

The **other services** sector (NACE 50.2 + 52.7 + 67 + (70–75) + 80 + 85 + (90–95)) contains a very widespread

variety of enterprises. It covers quite diversified services such as real estate agencies, education and health services, research and development services, entertainment and personal services, which together provide 21% of total employment in Europe. The share of SMEs in salaried employment is relatively low (54% in 1992). The very dispersed nature of activities in this sector makes this level of aggregation less useful. Within the present framework of BACH, it is not, however, possible to disaggregate further. The sector is nevertheless included in the analysis due to its increasing importance in terms of value added and employment.

2. European average

The **European average** (EU-8) for this part is based on data from Austria, Belgium, France, Italy, Netherlands, Spain, Sweden and the UK. Hence, Denmark, Germany and Portugal have been excluded because of lack of data on the service sectors. This explains why the figures for the manufacturing sector differ slightly from those presented in part 1.

From 1986–91 there are some missing values. Belgian data are available from 1989, Portuguese from 1990 and Swedish from 1991. Data from the other countries are available for the whole period. Therefore, the comparability is reduced for 1990 and previous years.

The weights for each country used to calculate the European average for 1986–95 are based on the average from 1990–94 of the share of value-added in the respective sectors within EU-8.

¹⁶ See Panorama of European Industry 1997 for information on European economic sectors.

¹⁷ Information on employment and firm size is based on *Enterprises in Europe*. Fourth Report. DG XXIII.

The share of fixed assets and tangible assets affects the value adjustments of the profit and loss accounts. Large tangible assets lead to large depreciations that are included in the profit and loss accounts. In this way the composition of assets influences the difference between levels of net and gross profitability (see section 2.4).

Financial fixed assets cover shares in affiliated undertakings, long term loans to groups and associated companies, long term own shares, other shares and other loans¹⁸.

¹⁸ The exact content may, however, vary slightly between countries.

TABLE 11 : Composition of balance sheets, average 1986–95; EUR-8

ASSETS	Manufacturing	Building & Civil Engineering	Trade	Transport & Communication	Other Services
Current assets	58.4	73.3	65.2	27.8	49.0
Fixed assets	41.6	26.7	34.8	72.2	51.0
Intangible	2.0	0.7	1.5	0.1	3.2
Tangible	26.1	16.5	23.9	65.9	27.4
Financial	13.5	9.5	9.4	6.2	20.4
LIABILITIES					
Own funds	33.8	23.0	30.8	33.7	32.9
Provisions etc.	8.6	6.4	4.3	8.9	6.3
Debt	57.6	70.6	64.9	57.4	60.8
Financial	17.9	16.0	18.3	16.3	17.5
Commercial	39.7	54.6	46.6	41.1	43.3

TABLE 12 : Share of financial assets in total assets

EUR - 8	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	86-95
Manufacturing Industries	8.8	8.9	10.6	12.1	13.7	15.3	15.6	16.9	17.1	16.0	13.5
Building and civil engineering	8.5	8.0	8.1	8.7	9.1	10.3	10.3	10.7	10.4	10.5	9.5
Trade	7.1	7.4	7.2	8.2	9.4	10.3	10.9	11.5	11.6	10.7	9.4
Transport and communication	2.9	3.2	4.1	4.5	5.3	5.6	8.5	8.8	8.9	9.8	6.2
Other services	14.3	12.9	13.7	27.2	25.5	22.4	21.5	22.1	23.1	21.6	20.4

TABLE 13 : Debt structure (debt with a maturity over one year relative to total debt)

EU-8	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	86-95
Manufacturing Industries	28.0	26.4	25.9	27.6	29.1	29.7	29.6	29.2	27.4	26.5	27.9
Building and civil engineering	19.9	18.3	17.4	18.7	17.4	16.6	17.5	17.3	17.1	18.8	17.9
Trade	16.1	16.2	16.9	17.4	18.8	20.5	21.2	21.4	19.9	19.2	18.8
Transport and communication	53.9	52.7	51.5	53.5	53.5	53.3	57.1	56.2	60.0	62.2	55.4
Other services	30.7	33.5	35.1	41.0	37.8	35.5	36.3	35.3	37.9	34.2	35.7

While the bulk of fixed assets are tangible assets, Table 12 reveals a remarkable trend towards increasing financial assets in manufacturing and transport and communication. The same trend, but more modest, can be identified for the trade and building sectors. The increasing share of fixed assets in manufacturing, trade and transport and communication¹⁹ is therefore linked to increasing shares of financial fixed assets and, to a lesser extent, increasing shares of intangible assets in those sectors. The increasing share of financial assets is probably due to phenomena like increased networking by enterprises, increased financial alliances, globalisation and outsourcing²⁰.

2.1.2. *Similar liability structures across sectors, except the building sector where the share of commercial debt is higher.*

Liabilities can be divided into three main categories : own funds, provisions and debts. Debts can be subdivided into financial debt and other debts, mainly commercial debts. As can be seen from Table 11, the composition of liabilities is very similar in 4 out of the 5 sectors analysed (the exception being the building sector). The share of own funds ranges between 30.8% and 33.8% and the overall debt ratio between 57.4% and 64.9% (slightly higher in the trade sector). By contrast, in the building sector, the own funds ratio is significantly smaller (23%) and the debt ratio is higher (70.6%). This higher degree of indebtedness is due to the higher share of commercial debts (54.6%), the share of financial indebtedness being similar to that of the other 4 sectors (16%).

As noted before, the indebtedness ratio has been falling for manufacturing enterprises since the early 90s. By contrast,

the indebtedness ratio has been stable for the trade sector, and increasing up to 1993 in the building sector and other services.

2.1.3. *Debt maturity is very long in transport and communication, very short in building and trade.*

The maturity of debts – the share of long term debts (more than 1 year) to overall debts – is presented in Table 13. The transport sector is distinguished from the 4 other sectors by a higher and increasing share of long term debt (reaching 62.2% in 1995). By comparison, the share of long term debt is only 26.5% in manufacturing. The explanation is probably linked to the increasing share of fixed assets in transport and communication²¹.

2.2. *Cost structures differ strongly across sectors – the trade sector, particularly, has a unique costs structure.*

Costs structures differ strongly between sectors (see Table 14). At one extreme, the ratio of purchases of goods and services to turnover in the trade sector is high (86.2 %), but staff costs (8.9 %) and financial charges (1.8 %) relatively small. This does not imply that employment expenses are low in the trade sector; rather it is linked to large turnover per employee.

¹⁹ This trend has been identified in other calculations based on BACH.

²⁰ For instance, an enterprise may choose to outsource service activities to a separate company, while keeping the shares as part of its financial assets.

²¹ Normally, one would expect enterprises to match the maturity of debts with the maturity of assets, in order to avoid costs related to debt conversion and to match the timing of interest payments with returns on assets. Therefore, increasing shares of fixed assets would be followed by larger shares of long term debt. This can be observed for transport and communication, but not for the building sector, where despite decreasing shares of fixed assets, the share of long term debt has risen.

TABLE 14 : Cost structure, averages 1986-95

EU-8	Manufacturing	Building & civil engineering	Trade	Transport & communications	Other services
Purchase of goods & services 70.5		68.1	86.2	51.6	56.7
Staff costs	19.3	25.4	8.9	33.4	33.9
Financial charges	3.1	3.3	1.8	7.3	5.2
Other costs	4.2	1.9	1.2	4.6	1
Net profit ratio	2.9	1.3	1.9	3.1	3.2
Turnover	100	100	100	100	100

In this sector, value added is determined by distribution and marketing, not production. Hence, value added is low but turnover high. At the other extreme, purchases of goods and services are relatively less important in the transport and communication sector (51.6%), but staff costs (33.4%) and financial charges (7.3%) are relatively high.

Whereas over the decade, the share of goods and services purchased to turnover increased for the building sector, no clear trends can be identified for other sectors. By contrast, a decreasing trend can be observed for the staff costs ratio in all sectors, except trade. For all sectors, the financial charges ratio reached its maximum in 1992–93, reflecting high short term interest rates.

2.3. Profitability

2.3.1. Gross operating profit ratios differ widely across sectors but their trends are similar (except for building and transport and communication).

The European gross profit ratios differ substantially from one sector to another (see Table 15), ranging from 5.6 % on average in trade to nearly 23% in transport/communication. However, the manufacturing industry, trade, transport/communication and other service sectors have all followed similar trends with falling gross profit ratios through the second half of the 80s reaching minima in 1991 (transport/communication), in 1992 for the trade sector and in 1993 for manufacturing and other services. Thereafter, gross profit ratios picked up. However, for the building sector, gross profit ratios continued to fall in 1995.

In the **building and civil engineering** sector, the gross profit ratio has declined from 8.1 % in 1992 to 6.3 % in 1995. Decreasing demand, particularly decreasing public demand, has put pressure on profitability as it tends to increase price competition in the sector. Procurement procedures by private and public customers also tend to increase price competition in the sector and reduce profitability. The falling trend has been notable in the UK, but also in Austria, Spain and, to a lesser extent, Germany.

2.3.2. Large sectoral differences in gross operating profit ratios cannot be found for net profit ratios

The large sectoral differences found for gross profit ratios cannot be found for net profit ratios (see Table 16). However, differences remain. The most profitable sector in the period under consideration was other services (3.2 %), closely followed by transport/communication (3.1 %) and manufacturing (2.9 %). The least profitable sector was building and civil engineering (1.3 %).

The net profit ratios fell throughout the late 80s in all sectors, touching bottom in 1992–93 for most sectors. The exception was the building sector, where the ratio sank to an overall minimum of –0.7 % in 1995.

Over the past decade, a particularly strong decline in the net profit ratio can be observed in **building and transport and communication**. In the former, net profits have been negative since 1991 as increasing shares of purchases of goods and services have squeezed profit margins (while the share of staff costs has remained constant). This development has been particularly acute in Italy, with extremely low and negative net profit ratios since 1992. Also in the UK and France, however, the net profit ratios were negative in 1995. In Sweden, the Netherlands and Spain, conversely, net profit ratios were relatively high in 1995. Even though **transport and communication** picked up after 1993, the associated net profit ratios have remained significantly lower than before 1992. No such change in the level can be found for gross profit ratios. This phenomenon was mainly caused by increasing value adjustments on non-financial assets relative to turnover in the sector.

2.3.3. Large differences in financial profitability across sectors.

The financial profitability ratios have been more volatile than either gross or net profit ratios (see Table 17). Again, there are relative large differences across sectors as the financial profit ratios range from –0.4 % in building to 10.4 % in trade and manufacturing. **As in the case of gross and net profit ratios,**

TABLE 15 : Gross operating profit ratios

EU-8	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	86–95
Manufacturing Industries	11.0	11.1	11.7	11.3	10.4	10.0	9.6	9.3	10.6	11.1	10.6
Building and civil engineering	7.5	7.9	8.0	8.0	7.5	7.1	8.1	7.0	6.4	6.3	7.4
Trade	6.7	5.7	6.0	5.7	5.7	5.2	5.0	5.1	5.3	5.4	5.6
Transport and communication	24.7	23.8	22.2	22.6	21.7	21.5	22.4	23.7	23.6	22.8	22.9
Other services	11.2	12.6	12.3	12.0	10.9	10.6	10.3	10.2	11.3	11.2	11.3

TABLE 16 : Net profit ratios

EU-8	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	86–95
Manufacturing Industries	2.5	3.7	4.2	4.4	3.3	2.5	1.2	0.7	3.2	3.7	2.9
Building and civil engineering	2.0	2.5	3.1	3.0	2.2	1.1	–0.3	0.0	–0.4	–0.7	1.3
Trade	2.0	2.2	2.3	2.2	2.1	1.6	1.2	1.2	1.9	1.9	1.9
Transport and communication	4.9	4.3	5.2	4.6	4.0	3.5	1.4	0.6	1.7	1.0	3.1
Other services	3.1	3.8	4.7	7.1	4.1	2.6	0.0	0.0	2.6	3.7	3.2

the financial profitability ratios declined in all sectors from the late 80s. However, in manufacturing, trade and other services, the ratio started increasing again in 1994. By contrast, in the building sector it has continued to decline.

2.4. Balance sheet structure and profitability

In Table 18, key indicators are summarised (ten year averages) and presented by sector ranked by their share of fixed assets in total assets. The table reveals a remarkable pattern linking sectoral balance sheet structure with enterprise performance. **The asset structure seems to determine not only the financial structure but also the profitability structure.**

Ranking the sectors according to the shares of fixed assets reveals similar ranking in financial structural indicators and profitability indicators. The cells for which the pattern is not complete are highlighted.

- High shares of fixed assets are associated with high own funds and low indebtedness. High own fund ratios are necessary to finance capital intensive sectors. In such sectors, loan providers will demand high risk sharing by external equity because commercial risks are higher. Tangible assets will typically be financed with long term loans, reflecting the depreciation of the capital goods invested. Therefore, the debt structure needs to be longer for high shares of tangible assets. Gross operating profit ratios need to be high in order to finance depreciation and large investments. Furthermore, capital intensive sectors probably face less competition (or potential competition) because of high sunk costs and entry barriers. This allows for higher profit margins.
- Conversely, high shares of current assets make the risks smaller, because such assets are easier to capitalise. Hence, the need for equity is smaller. Furthermore, current assets are easier to finance by short term commercial debt.

As the gross operating profit ratio and the net profit ratio are calculated on the basis of turnover, the comparison is influenced by the speed at which assets are turned over. This

speed – called **velocity of assets** – decreases with the share of fixed assets. This means that one unit of asset in the trade sector gives much more turnover than one unit of asset in the transport and communication sector. Therefore, in sectors with high shares of fixed assets (such as transport), the velocity of assets is low and profits relative to assets (financial profitability) will be low while profits relative to turnover (gross or net profit) will be high²². The opposite is true for sectors with high shares of current assets (such as trade)²³.

3. THE SITUATION OF EUROPEAN SMEs

This section presents key figures offering a picture of European Small and Medium-sized Enterprises (SMEs), compared with Large enterprises (LEs). SMEs account for 99.8% of all companies, 66% of total employment and 65% of business turnover in the European Union²⁴. They play a very important role in European competitiveness, in particular in the area of job creation: two thirds of total European employment is accounted for by SMEs²⁵ with less than 250 employees.

Although SMEs make an important contribution to competitiveness, their financial structure differs substantially from that of LEs. In particular, SMEs often suffer more difficulties than LEs accessing capital.

Without intending to present an exhaustive review of the economic literature, the main explanations for these difficulties are generally that:

- SMEs have a lower probability of survival than LEs. For this reason, financial institutions assess SMEs as inherently more risky;

²² Financial profitability = Net profitability x velocity of own funds. ↔

$$\frac{\text{net profit}}{\text{own funds}} = \frac{\text{net profit}}{\text{turnover}} \times \frac{\text{turnover}}{\text{own funds}}$$

²³ The building sector does not completely follow the described pattern. For example, in spite of a limited share of fixed assets in the sector, its financial profitability is relatively low. This can be explained by the extensive use of leasing of production equipment, which might bring down the share of fixed assets to an "artificially" low level. In general, however, it is difficult to compare the building sector's data with other sectors, because of sectoral particularities related to timing of payments, networking of subcontractors, etc.

²⁴ Source: EUROSTAT Enterprises in Europe, 4th Report, 1996.

²⁵ See definition in Box 10.

TABLE 17 : Financial profitability

EU-8	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	86-95
Manufacturing Industries	8.6	12.2	13.3	13.9	10.1	6.9	2.3	0.5	7.8	10.4	8.6
Building and civil engineering	7.3	10.2	13.2	12.7	10.3	6.6	0.2	0.8	-1.7	-4.0	5.6
Trade	12.2	12.7	13.5	12.9	11.6	9.0	6.2	5.7	9.4	10.4	10.4
Transport and communication	9.8	8.9	9.1	7.9	6.1	5.6	4.4	1.2	2.9	0.4	5.6
Other services	9.0	11.7	11.9	12.2	8.9	5.8	0.0	2.4	6.5	8.4	7.7

TABLE 18 : Ranking of EU-sectors by key figures (average 1986-95)

EU-8	Fixed assets	Tangible assets	Own funds	Indebtedness	Debt structure	Gross profit	Net profit	Financial profitability
Building	26.7	16.5	23.0	70.6	17	7.4	1.3	5.6
Trade	34.8	23.9	30.8	64.9	17	5.6	1.9	10.4
Manufacturing	41.6	26.1	33.8	57.6	26	10.6	2.9	8.6
Other services	51.0	27.4	32.9	60.8	35	11.3	3.2	7.7
Transport & Communications	72.7	65.9	33.7	57.4	54	22.9	3.1	5.6

Box 10 : Definition of SMES

Until 1994, the definition of SMEs in the BACH layout was based on national definitions for each country. Usually, these definitions used as criterion the number of employees, which could vary from one country to another. Occasionally, turnover was used to distinguish SMEs from LEs.

Henceforth, a common criterion is used in the BACH database (and has been extrapolated to previous years):

- small enterprises are those with turnover below ECU 7 million;
- medium-sized enterprises are those with turnover between ECU 7 million and ECU 40 million;
- large enterprises are those with turnover in excess of ECU 40 million.

It should be emphasised that this definition does not include the number of employees, the balance-sheet total and the

membership in a group unlike the standard SME-definition used by the European Commission.

It is important to highlight that there could be some biases in the study:

- due to lack of information, the representativeness of small and medium-sized enterprises has not been taken into account. SME figures are calculated from a simple aggregation of the absolute figures for small and medium-sized enterprises;
- in the UK, the Netherlands and United States lack of information on small enterprises means that only medium-sized enterprises are taken into account in calculating ratios;
- missing figures for German SMEs in 1995 have been replaced by 1994 figures.

- Larger firms have better access to a broad range of external funds (including bonds, equity and loans) than SMEs;
- Financial institutions often charge higher interest rates to SMEs than to bigger firms in order to compensate for higher costs of information collection, smaller volumes of external financing and the greater risk of failure;
- For many firms, "insiders" (the entrepreneur) have better information about the expected profits than external institutions (asymmetric information). This is particularly true for SMEs, as information on factors affecting profitability is less visible for lenders and investors. Such lack of information leads to higher market interest rates to compensate for risk, crowding out low-risk, low-return borrowers, leaving a relatively higher number of high risk/return borrowers in the market. Charging higher interest rates may therefore not be in banks' interest as low-risk borrowers are driven from the market (adverse selection effect). For this reason banks may operate a policy of credit rationing;
- Finally, European stock markets appear less developed than the US one. In 1995, the European Union represented only 22.9% of the world market capitalisation. Moreover, the role of SMEs in these markets is largely insignificant, one main reason being liquidity. Poor liquidity makes it difficult to liquidate an investment, the risk of a loss due to the lack of realisable assets. This is largely explained in Europe by many firms' tendency not to issue shares because managers fear being exposed to hostile take-overs. They would prefer to accept higher costs of a bank loan or give up a project but stay independent²⁶.

In this context, the main questions are: do SMEs have the same type of performances as LEs? Do SMEs and LEs have the same type of financial structure? Do enterprises in certain size-classes suffer specific disadvantages? These questions are addressed in this third part of supplement A. First, we analyse the performances and financial structures of European LEs and SMEs over the last decade. A brief comparison with the United States and Japan is made when the data are available and sufficiently comparable. Secondly, we focus on differences in the performance and structure of LEs and SMEs in the Member States.

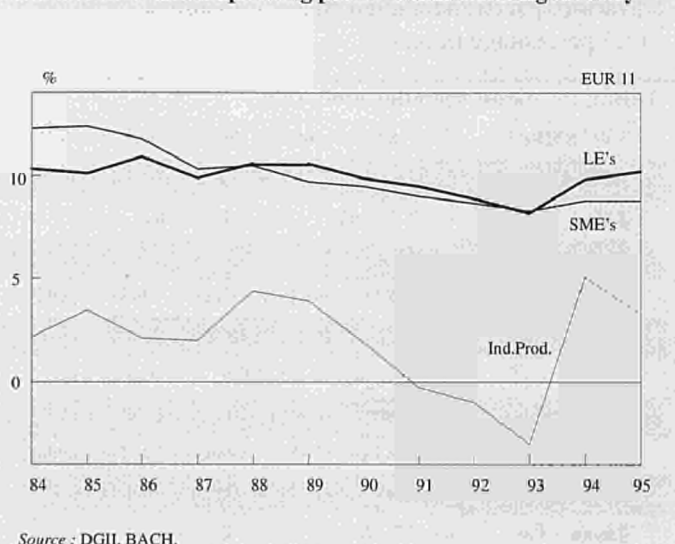
3.1. Comparison of European, Japanese and American SMEs

3.1.1. SMEs seem to have a lower gross operating profit ratio than LEs and a poorer capacity to benefit from periods of recovery

In 1995, the gross operating profit ratio of SMEs stabilised at 8.8%, the same result as in 1994. The gross operating profit ratio of LEs, on the other hand, recorded an increase of 0.4 percentage points, from 9.8% to 10.2%. However, this improvement was less marked than in 1993/1994 when the gross operating profit ratio of LEs increased by 1.6 percentage points. This slowdown can be largely linked with the modest performance of industrial production in 1995 compared with 1994 (see part 1 above). Nevertheless, more recently, **European LEs seem to have been more resistant to the pause of growth of industrial production than SMEs.**

²⁶ Source: Background paper for the 1997 G7 Denver Summit, OECD, 30 May 1997, "small businesses, job creation and growth".

GRAPH 13 : Gross operating profit – Manufacturing industry

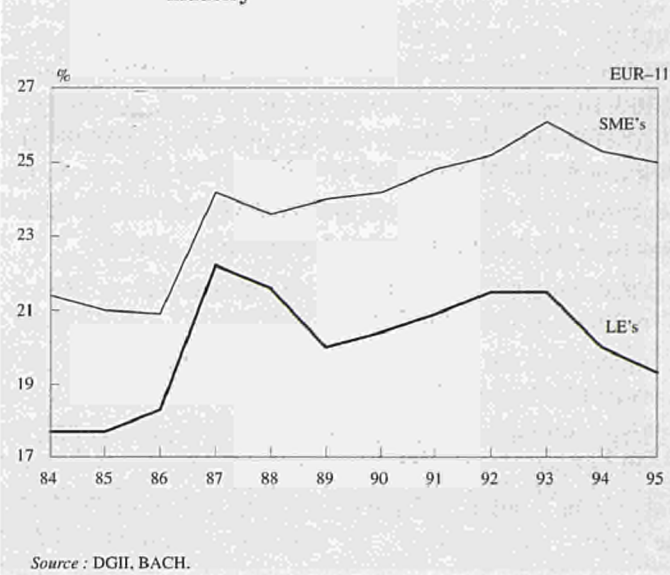


Something similar can be observed in the United States, where SMEs' 1995 gross operating profit ratio even decreased, whilst increasing slightly for LEs. In Japan, despite the acceleration of growth in 1995, the gross operating profit ratio of SMEs decreased from 7.9% to 7.5%, a decrease of 0.4 percentage points, while increasing for LEs, from 10.1% to 10.5%, an increase of 0.4 percentage points. Japanese SMEs have benefited less from the acceleration of industrial production growth than LEs.

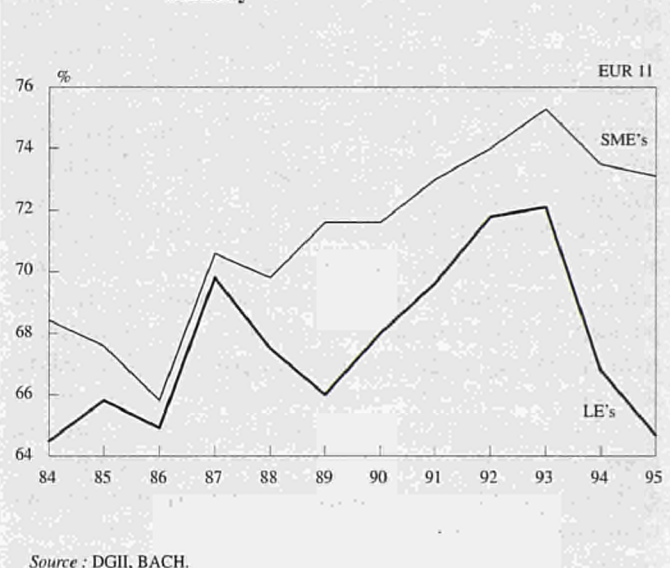
A general overview of the past ten years leads us to the following remarks:

- Firstly, graph 13 shows two distinct periods in the formation of profitability. Before 1988, European SMEs recorded better performances than LEs in terms of gross operating profit ratio. After 1988, the results reverse: **over the past 8 years, the profitability of European SMEs has been lower than that of LEs.** From 1986 to 1995, the spread between SMEs' and LEs' gross profit ratios has been 0.3 percentage points in favour of LEs. This spread seems to be increasing significantly in the most recent period as it was 1.4 percentage points in 1995;
- Secondly, comparisons between industrial production and the performances of European SMEs and LEs shows that the gross profit ratio of firms is clearly linked to business cycles. During recessions (between 1989 and 1993), the LEs' profitability decreased faster than SMEs'. On the other hand, during upturns of the business cycle, LEs' gross profitability improves faster than SMEs' profitability. **In other words, LEs benefit more from periods of economic recovery than SMEs. Conversely in periods of recession, SMEs seem more resistant than LEs.**²⁷
- Despite the persistence of gaps between firms of different sizes, **European firms' profitability gaps (0.3% over the period 1986–1995) appear much smaller than those observed in Japan or the United States.** In Japan, the gap averages 2 percentage points over the period 1986–1995; in the United States, the gap is even greater (3.3 percentage points).

GRAPH 14 : Share of staff cost to turnover – Manufacturing industry



GRAPH 15 : Share of staff cost to value added – Manufacturing industry



²⁷ These results may be affected by the high rate of mortality of SMEs. Particularly, in period of recession, SMEs disappear quicker from the sample than LEs. This can improve the results artificially.

TABLE 19 : Gross operating profit ratio

SMEs	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85–93	86–95
EUR-11	12.3	12.4	11.8	10.3	10.5	9.7	9.5	9.0	8.7	8.3	8.8	8.8	10.0	9.6
Japan	7.8	7.7	7.4	8.5	8.9	9.2	9.1	9.5	8.9	7.9	7.9	7.5	8.6	8.5
United States	7.9	7.2	7.2	7.3	7.7	7.4	7.0	6.6	7.2	7.6	8.4	8.0	7.2	7.4
LEs	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85–93	86–95
EUR-11	10.3	10.1	10.9	9.9	10.6	10.6	9.9	9.5	8.9	8.2	9.8	10.2	9.8	9.9
Japan	11.0	10.4	9.6	10.8	11.7	11.7	11.1	10.3	9.7	9.4	10.1	10.5	10.5	10.5
United States	10.9	10.1	10.3	11.2	11.4	10.7	10.4	9.3	9.7	10.3	11.8	12.0	10.4	10.7
Spreads	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85–93	86–95
EUR-11	-2.0	-2.2	-0.9	-0.4	0.1	0.8	0.4	0.4	0.3	-0.1	1.0	1.4	-0.2	0.3
Japan	3.2	2.7	2.2	2.3	2.7	2.5	2.0	0.9	0.9	1.5	2.2	2.9	1.9	2.0
United States	3.0	2.9	3.2	3.9	3.7	3.3	3.3	2.7	2.5	2.8	3.4	4.0	3.1	3.3

TABLE 21 : Share of staff cost in value added

SME	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	68.4	67.6	65.8	70.6	69.8	71.6	71.6	73.0	74.0	75.3	73.5	73.1	71.0	71.8
Japan	71.1	71.0	71.7	69.5	68.0	66.5	66.6	66.9	69.9	73.0	73.0	73.4	69.2	69.8
United States	-	-	-	-	-	-	-	-	-	-	-	-	-	-
LEs	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	64.5	65.8	64.9	69.8	67.5	66.0	68.0	69.6	71.8	72.1	66.8	64.7	68.4	68.1
Japan	52.8	54.7	57.9	54.8	51.8	52.0	53.2	55.7	58.4	60.2	58.4	57.0	55.4	55.9
United States	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Spreads	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	-3.9	-1.8	-1.0	-0.8	-2.3	-5.5	-3.6	-3.3	-2.3	-3.2	-6.7	-8.4	-2.7	-3.7
Japan	-18.3	-16.3	-13.8	-14.6	-16.3	-14.5	-13.4	-11.2	-11.5	-12.7	-14.6	-16.5	-13.8	-13.9
United States	-	-	-	-	-	-	-	-	-	-	-	-	-	-

- during periods of expansion, for example after 1993, LEs' profitability seems to increase much faster than that of SMEs. In 1995, the gap between SMEs and LEs became historically wide (1.3 percentage points in 1995 compared with an average 0.1 percentage points over 1985-1993).

Although the evolution of European firms' net profit ratio clearly reflects the gross profit ratio, implying that the main discriminating factor between class sizes is weight of staff costs, it is still interesting to look at the composition of charges included in the calculation of net profitability:

- Depreciation charges are slightly heavier for European SMEs than for LEs. In 1995 as well as in 1994, the gap between them was 0.5 percentage points. Such charges have evolved steadily over the past ten years for both SMEs and LEs;
- Financial charges are quite similar for LEs and SMEs in 1995 (respectively 2.7% and 2.6% of turnover). However, LEs' financial results are much higher than SMEs', showing LEs' superior capacity to generate financial income.

3.1.4. Since 1994, SMEs' financial profitability has slipped below LEs' and the gap is increasing.

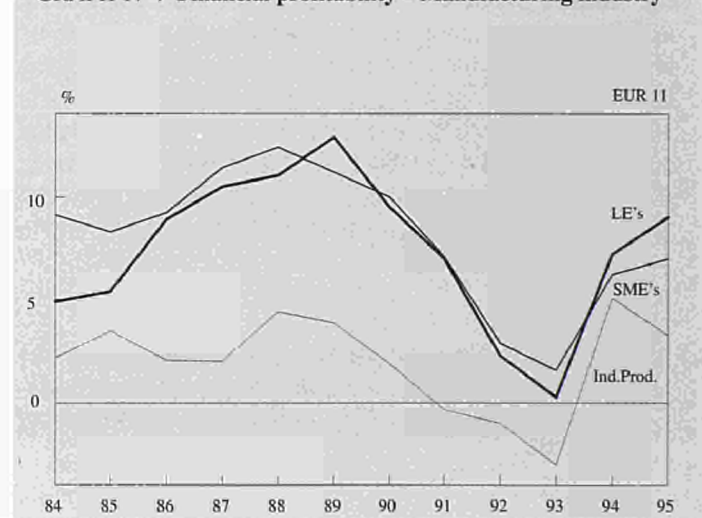
In 1995, European LEs' net profitability increased faster than that of European SMEs. LEs' profitability increased markedly from 7.2% in 1994 to 9% in 1995, an increase of 1.8 percentage points; but only by 0.8 percentage points for SMEs, from 6.2% in 1994 to 7% in 1995. **The difference in the financial**

profitability of SMEs and LEs was historically high in 1995 at 2 percentage points.

This disparity can be explained by two items: the evolution of net margins and the velocity of own funds²⁹:

²⁹ Defined as the ratio turnover / own funds. In other words, when the velocity of own funds increases, less own funds are necessary in order to generate a given turnover. The link between financial profitability and the net profit ratio can be explained by the following equation: net profit/own funds = net profit ratio x velocity of own funds where net profit ratio = net profit / turnover and velocity of own funds = turnover / own funds.

GRAPH 17 : Financial profitability – Manufacturing industry



Source : DGII, BACH.

TABLE 22 : Net profit ratio

SMEs	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	4.3	3.7	3.3	3.0	3.2	2.7	2.2	1.7	0.8	0.5	1.8	1.8	2.3	2.1
Japan	1.1	1.0	0.8	1.4	1.7	1.7	1.5	1.2	0.7	0.1	0.3	0.6	1.1	1.0
United States	2.9	2.4	2.4	2.5	3.3	3.2	3.0	2.5	3.1	3.5	4.3	3.7	2.9	3.1
LEs	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	1.8	2.0	2.9	3.2	3.5	3.9	2.9	2.3	1.0	0.6	2.8	3.2	2.5	2.6
Japan	2.3	2.1	1.6	2.1	2.7	3.0	2.8	2.2	1.3	1.0	1.3	2.0	2.1	2.0
United States	5.1	4.2	4.2	5.6	6.2	5.1	3.9	2.3	0.3	2.6	5.6	6.2	3.8	4.2
Spreads	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	-2.5	-1.8	-0.3	0.2	0.3	1.2	0.7	0.6	0.2	0.1	1.0	1.3	0.1	0.5
Japan	1.2	1.1	0.8	0.7	1.0	1.2	1.3	1.0	0.6	0.9	1.0	1.4	1.0	1.0
United States	2.2	1.8	1.8	3.1	2.9	1.9	0.9	-0.2	-2.8	-0.9	1.3	2.5	0.9	1.0

TABLE 23 : Financial profitability

SMEs	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	9.1	8.3	9.2	11.4	12.4	11.2	10.0	7.1	2.9	1.6	6.2	7.0	8.2	7.9
Japan	8.6	8.1	5.9	9.4	11.9	11.2	10.1	8.0	4.4	0.5	1.7	3.6	7.7	6.7
United States	13.7	11.3	10.7	11.4	15.4	15.5	13.7	11.4	14.3	16.3	20.3	17.7	13.3	14.7
LEs	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	4.9	5.4	8.9	10.5	11.0	12.9	9.5	7.0	2.3	0.3	7.2	9.0	7.5	7.8
Japan	8.7	7.5	5.1	6.1	7.6	7.5	7.2	5.5	3.1	2.3	2.9	4.4	5.8	5.2
United States	12.5	9.9	9.7	13.0	14.6	12.0	9.0	5.0	0.7	6.5	13.7	14.5	8.9	9.9
Spreads	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	-4.1	-2.9	-0.4	-1.0	-1.5	1.7	-0.5	-0.1	-0.7	-1.3	0.9	2.0	-0.7	-0.1
Japan	0.1	-0.6	-0.8	-3.3	-4.3	-3.7	-2.9	-2.6	-1.3	1.8	1.1	0.8	-2.0	-1.5
United States	-1.2	-1.4	-1.0	1.5	-0.8	-3.5	-4.8	-6.4	-13.7	-9.9	-6.7	-3.1	-4.4	-4.8

- The large increase in the LEs' financial profitability can be explained by the slight increase of the net profit ratio between 1994 and 1995 (by 0.4 percentage points) and the marked increase in the velocity of own funds: the ratio turnover / own funds has increased from 3.6 in 1994 to 3.8 in 1995 (a 5.6% increase);
- on the other hand, the slight increase of financial profitability observed for SMEs is not due to an increase in the net profit ratio, which was stable between 1994 and 1995, but to the velocity of own funds which has increased from 3.7 to 3.8.

It is important to highlight that this situation is quite new. **An analysis of the past ten years shows that until 1994, European SMEs' financial profitability was almost always higher than that of large enterprises.** European SMEs were much less capitalised than LEs. This offsets the relative weakness of net margin and permitted a better level of financial profitability for SMEs by increasing leverage. The recent evolution could have a significant impact on the development of European stock and venture markets specifically designed for SMEs by deterring investors.

In the United States, the picture is radically different. SMEs have had better financial profitability than LEs, not only in 1995 but over the last decade, despite the relative weakness of American SMEs' net profit ratio compared to LEs. The velocity of own funds is much smaller for LEs (2.3 in 1995) than for SMEs (4.7 in 1995). Thus, leverage is much higher for SMEs than LEs.

3.1.5. Financial structures: SMEs are less capitalised than LEs in Europe and Japan, the opposite is true in the United States.

In 1995, European SMEs' own funds ratio remained quite stable at 32.3%. By contrast, the own funds ratio of European LEs decreased from 34.3% in 1994 to 33.9% in 1995. However, the spread between LEs and SMEs remained quite significant and in favour of LEs: in 1995, the spread was 1.6 percentage

GRAPH 18 : Own funds ratio - Manufacturing industry

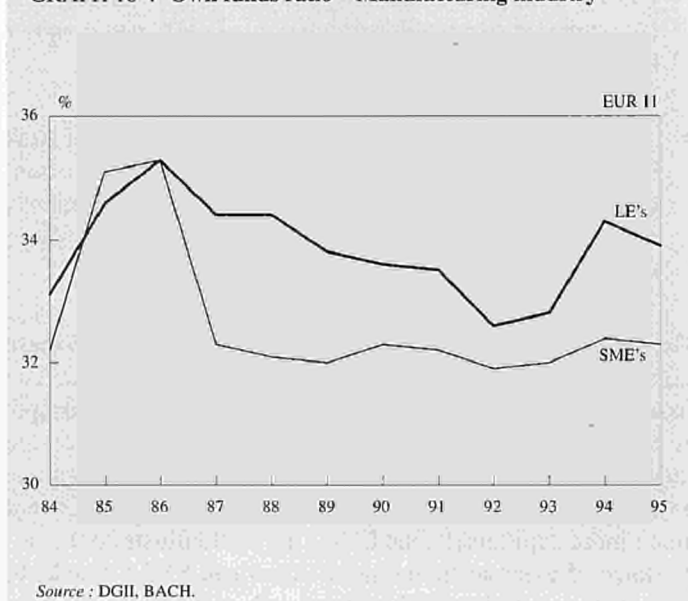


TABLE 24 : Own funds ratio

SMEs	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	32.2	35.1	35.3	32.3	32.1	32.0	32.3	32.2	31.9	32.0	32.4	32.3	32.8	32.5
Japan	19.4	19.6	20.8	21.0	20.8	21.1	20.9	21.6	21.6	20.8	21.3	20.9	20.9	21.1
United States	45.7	45.0	45.3	45.6	45.4	46.1	46.1	46.4	46.6	45.9	45.3	44.2	45.8	45.7
LEs	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	33.1	34.6	35.3	34.4	34.4	33.8	33.6	33.5	32.6	32.8	34.3	33.9	33.9	33.8
Japan	29.8	31.9	33.5	35.2	36.7	38.4	38.5	38.9	39.6	40.6	41.2	41.7	37.0	38.4
United States	49.6	48.0	46.9	46.0	44.7	42.8	42.7	42.6	39.2	38.7	40.1	42.3	43.5	42.6
Spreads	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	0.9	-0.5	0.0	2.1	2.3	1.8	1.3	1.3	0.7	0.8	1.8	1.6	1.1	1.4
Japan	10.3	12.3	12.7	14.2	15.9	17.2	17.6	17.3	18.0	19.8	19.9	20.8	16.1	17.3
United States	3.9	3.0	1.6	0.3	-0.7	-3.3	-3.4	-3.9	-7.4	-7.2	-5.1	-1.9	-2.3	-3.1

TABLE 25 : Overall debt ratio

SMEs	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	61.4	58.7	59.1	58.6	59.0	60.2	60.1	59.8	59.9	59.7	59.2	59.4	59.5	59.5
Japan	75.5	75.0	74.2	73.3	73.9	74.0	74.6	73.9	73.9	74.3	74.3	74.5	74.1	74.1
United States	53.4	54.0	53.4	53.3	53.6	52.8	52.8	52.3	52.3	53.0	53.6	54.5	53.1	53.2
LEs	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	59.4	57.6	56.6	47.9	47.3	51.0	50.4	49.6	50.2	49.4	48.4	48.5	51.1	49.9
Japan	64.1	62.0	60.3	58.6	57.1	55.8	55.9	55.6	54.8	53.7	53.0	52.9	57.1	55.8
United States	46.5	48.2	50.0	51.2	52.7	54.2	54.5	54.2	55.8	55.6	54.8	53.9	52.9	53.7
Spreads	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	-1.9	-1.1	-2.6	-10.7	-11.7	-9.2	-9.7	-10.2	-9.7	-10.3	-10.8	-10.9	-8.4	-9.6
Japan	-11.3	-13.0	-14.0	-14.6	-16.9	-18.2	-18.7	-18.3	-19.1	-20.6	-21.3	-21.7	-17.1	-18.3
United States	-6.8	-5.8	-3.4	-2.1	-0.9	1.4	1.8	1.8	3.6	2.6	1.2	-0.7	-0.1	0.5

points. European SMEs appear less capitalised than LEs. The same remark can be made over the past ten years, when the share of own funds of LEs has consistently exceeded that of SMEs.

These characteristics can be explained by various factors:

- firstly, European SMEs may have difficulties in obtaining equity capital funding. The recent development of new stock markets in Western Europe (EASDAQ, AIM in the United Kingdom, Nouveau Marché in France, Neue Markt in Germany) will perhaps contribute to better equity financing for SMEs in Europe in the future;
- secondly, it could be argued that entrepreneurs prefer bank loans to equity because then they do not have to share control with outsiders. This assumption could be particularly true for SMEs because the financial structure is more based on family capital than in LEs.

The same type of observation can be made for Japan. Japanese LEs are much more financed by own funds than SMEs. The spread between the two sizes is even greater than in Europe: on average between 1986 and 1995, the spread between the share of own funds of LEs and SMEs was 17.3 percentage points. On the other hand, in the United States, SMEs appear much more capitalised than LEs. This could illustrate the importance of external financing to American SMEs thanks to the organisation of capital markets and, particularly, the success of venture funds devoted to SMEs.

3.1.6. Debt analysis: SMEs are more indebted than LEs and have succeeded less in reducing their indebtedness ratio over the last ten years.

Analysis of indebtedness shows that the overall debt ratio remained quite stable for European SMEs and LEs between 1994 and 1995. Unsurprisingly, the overall debt ratio is much higher for SMEs than for LEs: the spread between the two sizes was 11 percentage points in 1995. However, it is important to highlight that construction of the ratio is largely influenced by the weight of Germany in the average.

GRAPH 19 : Financial indebtedness – Manufacturing industry

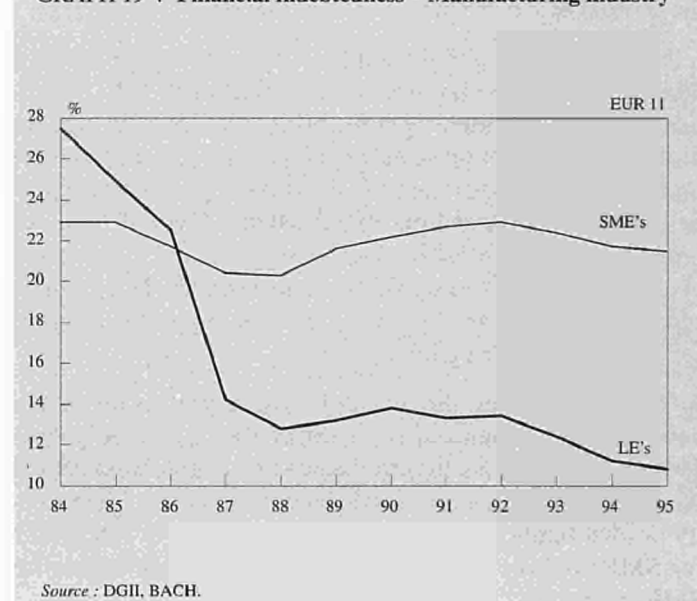


TABLE 26 : Financial indebtedness

SMEs	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	22.9	22.9	21.7	20.4	20.3	21.6	22.2	22.7	22.9	22.4	21.7	21.5	21.9	21.7
Japan	34.0	34.6	36.5	35.5	36.1	36.2	36.1	37.0	39.5	41.4	41.2	40.4	37.0	38.0
United States	19.1	19.7	19.4	19.5	21.0	20.7	20.5	19.9	19.6	18.3	19.3	20.4	19.8	19.9
LEs	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	27.5	24.9	22.5	14.2	12.8	13.2	13.8	13.3	13.4	12.4	11.2	10.8	15.6	13.8
Japan	23.6	23.2	22.9	20.3	17.0	13.6	13.8	14.4	15.6	16.6	15.9	15.1	17.5	16.5
United States	6.1	6.1	7.1	7.9	9.2	9.6	10.2	9.2	8.8	8.1	8.0	8.1	8.5	8.6
Spreads	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	85-93	86-95
EUR-11	4.5	2.0	0.8	-6.2	-7.4	-8.4	-8.4	-9.4	-9.5	-10.0	-10.5	-10.6	-6.3	-8.0
Japan	-10.4	-11.4	-13.7	-15.2	-19.0	-22.6	-22.3	-22.5	-23.9	-24.8	-25.3	-25.2	-19.5	-21.5
United States	-13.0	-13.7	-12.2	-11.7	-11.8	-11.1	-10.2	-10.7	-10.9	-10.2	-11.3	-12.4	-11.4	-11.2

The massive provisions for liabilities and charges made by large German enterprises reduce their need for external financing, so that the gap between LEs and SMEs is particularly wide (almost 30 percentage points in 1995). The discrepancy can be explained by European SMEs' difficulties in gaining access to stock markets, so that they prefer to finance their projects either by self financing or by loans.

A more precise analysis based on financial indebtedness shows a slightly different picture. Over the past years, a clear trend of decreasing indebtedness appears. This trend is more important for LEs than for SMEs, which explains why the spread between SMEs and LEs has increased markedly (from 6.2 percentage points in 1987 to 10.6 percentage points in 1995). This period corresponds to high levels of interest rates in Europe so that firms could have tried to reduce their indebtedness in order to reduce their financial charges. LEs may have been more successful than SMEs because they have access to a wider variety of financing sources. On the other hand, SMEs rely more on the banking system as their access to alternative sources of financing is much more limited.

In Japan, SMEs rely more on the banking system than LEs. They appear to be much more indebted than European SMEs: in 1995, their overall indebtedness ratio was 74.5% and the spread between SMEs and LEs was also higher (21.7 percentage points). In the United States, however, there is much more convergence between SMEs and LEs: their overall debt ratios are quite similar, 54.5% and 53.9% respectively, further indication of the importance of capital markets devoted to SMEs in the United States.

3.2. The situation of SMEs by Member State.

SMEs have a very important role to play in terms of value added, employment and innovations in all Member States. There are, however, differences from country to country, as can be seen from Table 27. In Europe, Italy has the highest number of enterprises, but at the same time the lowest average firm size. Austria and the Netherlands, however, have the largest average firm size of the Member States. The share of SMEs in employment is relatively large³⁰ in the South (Spain, Italy, Portugal) along with Austria and Denmark. In Italy and Spain, indeed, very small enterprises are dominant. Large enterprises are dominant in the largest Member States (UK, Germany, France,) and Belgium.

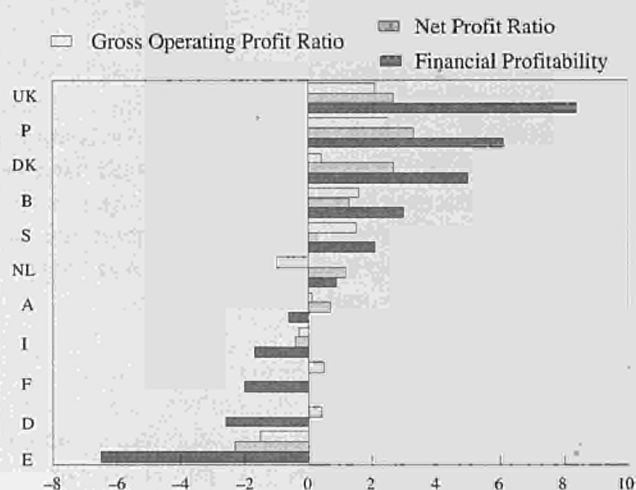
In this part we focus on differences in performance and structures of LEs and SMEs in the Member States by studying the differences (spread) that can be observed in key indicators for these two categories of enterprises. All figures are averages based on the years for which data are available: 1986 to 1995.

3.2.1. The conclusion that European SMEs' profitability is less than that of LEs holds only for some Member States (Belgium, Denmark, Portugal, Sweden and the UK). In other Member States the situation is more ambiguous.

Graph 20 shows a remarkable correspondence between the spreads³¹ of the three profitability indicators. The profitability indicators are strongly linked to each other in each country. There is, however, a wide dispersion between the profitability spreads in the different Member States. In 5 out of the 11 Member States considered (Belgium, Denmark, Portugal, Sweden and the United Kingdom), LEs' profitability is higher

GRAPH 20 : Spread in profitability

Average 1986-95



Source : DGII, BACH.

³⁰ Above the European average.

³¹ In graphs 20 to 26, the spreads are defined as the differences between the ratios observed for LEs and SMEs, a positive spread corresponding to a higher value for LEs.

TABLE 27 : SMEs in Member States (1995)

	A	B	DK	D	E	F	I	NL	P	S	UK	EU15
Number of enterprises (1.000)	145	410	150	2670	2200	1965	3365	390	580	415	2565	16040
Average enterprise size (number of employees)	13	7	9	9	5	7	4	11	5	5	8	6
Size-class dominance in employment	SME	Large	SME	Large	Very small	Large	Very small	SME	SME	SME	Large	SME
Share of SMEs in total employment 1992 (%)	68	56.2	72.5	59.9	81.1	63.4	78.7	60.9	77.5	65.2	57.7	66.2

Source: The European Observatory for SMEs, Annual report 1996 and European Commission: Enterprises in Europe, fourth report.
Size class dominance = size class which represents the largest share of total employment

than that of SMEs, whatever the indicator of profitability considered. By contrast, in 4 Member States (Austria, France, Germany and Italy) gross and net profitability are not significantly different in LEs and SMEs. In these countries, financial profitability is somewhat higher in SMEs than in LEs.

The situation in **Spain** is remarkable : SMEs have been substantially more profitable than LEs, contrary to general findings and conclusions in the previous part. The major reason for this was a remarkable drop in the net and gross operating profitability of large enterprises at the beginning of the 90s, whereas SMEs' profitability only dropped modestly. According to figures presented in the Banco de España Economic Bulletin of January 1997, gross profitability in Spanish enterprises was extremely low in 1993, improved rapidly in 1994 and slowed in 1995. Furthermore, SMEs had higher gross profitability and financial profitability than LEs in 1994 and 1995.

3.2.2. Cost structures diverge significantly between SMEs and LEs : SMEs face lower costs of intermediate products and services but higher staff costs and financial charges.

Lower costs of intermediate products and services for SMEs

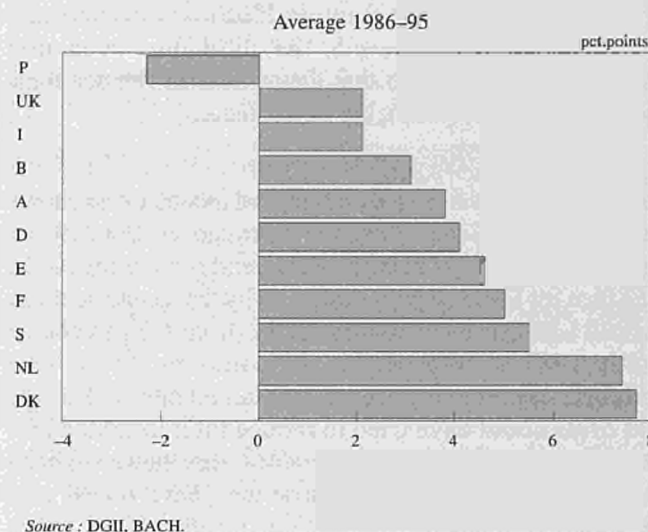
The shares of purchases of goods and services differed significantly between SMEs and LEs in Europe (see graph 21). For all Member States, this share is higher in LEs than in SMEs, except Portugal (less than -2 percentage points). **Consequently, the share of value-added in turnover is significantly larger in SMEs than in LEs in nearly all Member States.** The differences are very large in Denmark (nearly 8 percentage points), Netherlands (7.5 percentage points) and Sweden (5.5 percentage points), whereas UK and Italy (over 2 percentage points) had small spreads.

Higher staff costs for SMEs

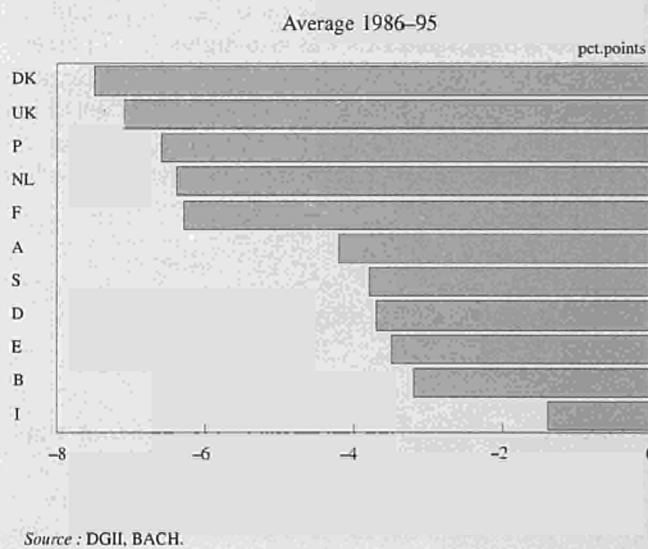
Turning to spreads in the shares of staff costs, a completely reverse picture emerges (see graph 22). **The shares of staff costs relative to turnover are higher for SMEs than for large enterprises in all the Member States.** This might reflect that SMEs are more labour-intensive than large enterprises³² and that large enterprises outsource relatively more than SMEs. Again, a large difference can be observed in Denmark (over 7 percentage points). The UK, Portugal, Netherlands and France have also had high discrepancies between SMEs and large enterprises for staff costs ratios, whereas they seem to have been moderate in Italy (just over 1 percentage point).

In the majority of countries, the lower costs of purchases of goods and services for SMEs identified above are offset by higher staff costs. This is, however, not the case for the UK and Portugal, where both the share of goods and services and the share of staff costs are higher for SMEs. This is probably the main reason for SMEs disappointing gross profit performance in these two countries. **Generally, however, the higher shares of turnover generated in SMEs are offset by larger shares of staff costs, resulting in gross operating profit ratios, which on average are modestly smaller in SMEs than in LEs.**

GRAPH 21 : Spread in purchase of goods and services



GRAPH 22 : Spread in staff costs



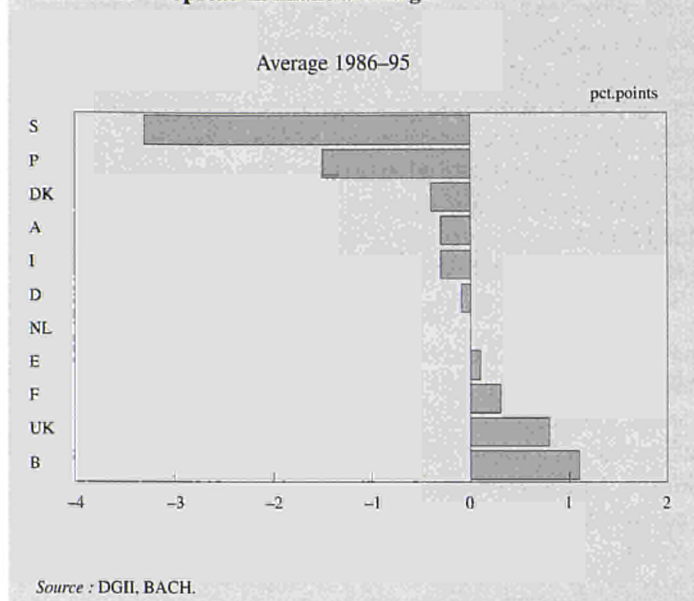
Higher financial charges for SMEs

Although financial charges generally cover only a modest part of the costs in enterprises (around 3% of turnover), clear differences can be found between LEs and SMEs. Graph 23 shows that the share of financial charges in turnover has been larger for SMEs than LEs in 6 Member States (Austria, Denmark, Germany, Italy, Portugal and Sweden). In Sweden, the spread has been very large (over 3 percentage points) probably reflecting high interest rates in Sweden³³ that apparently mainly

³² According to the European Observatory for SMEs (1996), labour productivity has increased by 2 % per annum in SMEs and by 2.5 % per annum in LEs during the period 1988-1997.

³³ It should be noticed that the Swedish data only cover all the period 1991-95. Therefore, the Swedish recession and exchange rate turbulence in the early 90s may have a relative large weight.

GRAPH 23 : Spread in financial charges



affected the SMEs. This might be because LEs have relative larger shares of debts in international capital markets and therefore are able to reduce the impact of high domestic interest rates. Portugal has also had significantly higher financial charges for SMEs. Conversely, financial charges have been higher in LEs than in SMEs in Belgium, France, Spain and UK, although the difference for Spain is negligible.

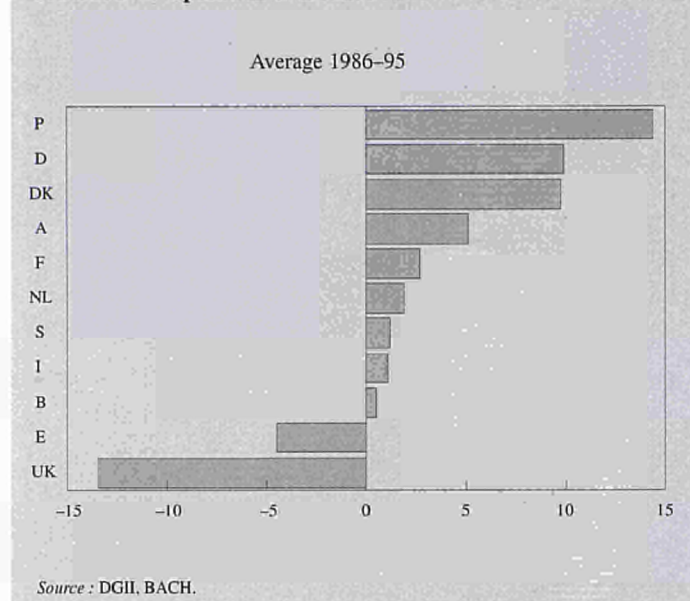
Calculations of the apparent interest rate can be obtained by dividing interest payments to financial institutions by the stock of financial debt³⁴. Unfortunately, information is only available for Spain, UK, France, Italy and Portugal. In all these countries the interest rates for SMEs are higher than for LEs.

3.2.3. Financial structure : SMEs are less capitalised and more indebted than LEs (except in the United Kingdom and Spain).

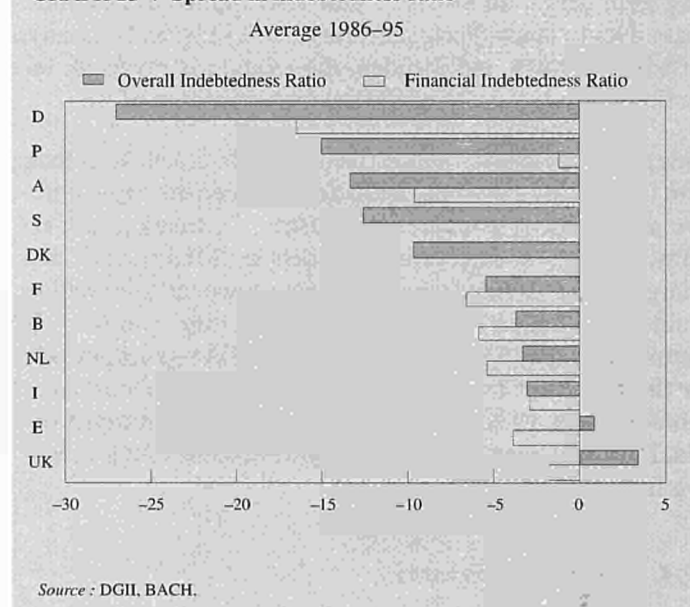
Differences in the financial structures of LEs and SMEs are illustrated in graphs 24 and 25. It should be emphasised that large indebtedness and low own funds are not necessarily signs of weak financial structures. For instance, in Germany, banks often have quite close links to enterprises, because they actively intermediate in order to provide own funds or subordinated loans to the enterprises. These close ties give the banks easier access to information and thus less insecurity in the credit rating. Furthermore, the very biased financial structure in Germany has not led to generally lower profitability in SMEs than in LEs.

In general, SMEs are less capitalised and more indebted than LEs. This conclusion is valid for all Member States except the UK and to a lesser extent Spain where LEs are characterised by higher indebtedness and smaller own funds ratios than SMEs. In fact, in the United Kingdom, the financial structure of SMEs is more similar to that observed in the United States. In both countries, financial systems are more market based.

GRAPH 24 : Spread in own funds ratio



GRAPH 25 : Spread in indebtedness ratio



Financial indebtedness is the part of indebtedness which stems from loans from credit institutions (banks, etc.). This ratio follows more or less the pattern of the indebtedness ratio. In the UK and Spain, where overall indebtedness is smaller in SMEs than in LEs, the opposite is true for financial indebtedness. Hence, bank loans are relatively more important for SMEs than for LEs in these two countries.

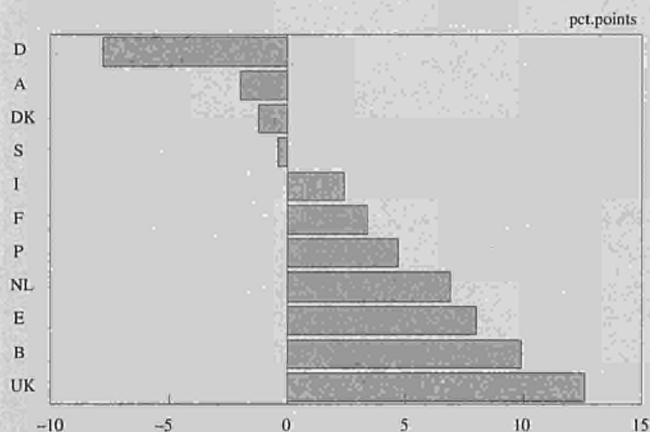
An interesting feature of European financial indebtedness is that the spread has been increasing rapidly over the decade in many countries, including Austria, Belgium, Spain and Italy (since 1992) and Germany. This has been caused by a reduction of the share of bank loans to total liabilities in LEs while the equivalent for SMEs has been constant. This development is probably due to increasing reliance on alternative sources of finance, including commercial papers and securitisation in LEs.

Graph 26 reveals substantial differences in the structure of debt between SMEs and LEs in European countries. In the UK apparently, the LEs have significantly higher proportions of

³⁴ It should be noticed that this 'interest rate' only covers financial debts and not commercial debts.

GRAPH 26 : Spread in debt structure

Average 1986-95



Source : DGII, BACH.

long term debt than SMEs³⁵. This also applies to Belgium, Spain, Netherlands, Portugal, France and Italy. In Germany, Austria, Denmark and Sweden, the relation is reversed, reflecting longer maturity of SME debts over those of LEs.

Enterprises typically finance fixed tangible assets with long term loans. This can imply a relation between the asset structure and the debt structure. In Austria, Denmark and Germany, the larger shares of long term debt in SMEs are reflected in larger shares of fixed tangible assets. However, this relation could not be found for Spain, France, Portugal and Italy. **It seems likely that SMEs – whenever possible – compensate for their smaller own funds by obtaining more long term debts. Indeed, this seems to be the case in Germany, Austria, Denmark and Sweden.** Portugal is an interesting exception from this observation.

3.2.4. Concluding remarks

The picture that emerges from comparing differences in key ratios for SMEs and LEs is one of considerable disparities between Member States. Table 28 presents a summary and overview of the previous results. A plus in the table corresponds

to a relatively favourable position for SMEs in the particular aspect, whereas a minus corresponds to an unfavourable position. A zero represents no difference or a difference which seems to be negligible. A glance over the Table shows that there are many more minuses than pluses reflecting the relatively disfavourable position of SMEs. The only general strength of SMEs is the relatively smaller purchase of goods and services, allowing them to have higher relative value added than large enterprises. Financial profitability is higher in some countries reflecting lower own funds ratios, but not in Spain.

Spain is the only Member State where the profitability of SMEs is higher than that of LEs whatever the indicator considered. This may be due to the fact, that the spread between staff costs in Spanish SMEs and LEs is relatively small. In addition, Spain has a small spread in financial charges. However, apparent interest rates are still higher for SMEs than LEs in Spain.

The following conclusions can be drawn:

- In terms of cost structure; SMEs in the Member States have larger staff costs and lower costs for purchases of goods and services than LEs (except for Portugal).
- In terms of financial structure; SMEs in the Member States have lower own funds (except Spain and the UK) and larger indebtedness than LEs (except the UK).

Two groups of Member States can be identified regarding the relative profitability of SMEs:

- Member States where SMEs' profitability is lower than that of LEs (Belgium, Denmark, Portugal, Sweden and the UK)
- Member States where SMEs' profitability is not very different to that of LEs (Germany, Austria, France, Italy and the Netherlands). No common features seem to characterise this group of countries. The financial charges are relatively similar, but as the share of financial charges in turn-over is quite modest this should not have substantial impact.

14 July 1997

³⁵ A possible explanation for the UK may be the relatively extensive issue of corporate bonds by LEs.

TABLE 28 : Overall comparison between SMEs and LEs in the Member States

Profitability	A	B	DK	D	E	F	I	NL	P	S	UK
- gross	0	-	0	0	+	0	0	+	-	-	-
- net	0	-	-	0	+	0	0	-	-	0	-
- financial	0	-	-	+	+	+	+	0	-	-	-
Costs											
- intermediate	+	+	+	+	+	+	+	+	-	+	+
- staff	-	-	-	-	-	-	0	-	-	-	-
- financial	0	+	0	0	0	0	0	0	-	-	+
Financial structure											
- own funds	-	0	-	-	+	-	0	0	-	0	+
- indebtedness	-	-	-	-	0	-	-	-	-	-	+
-financial indebtedness		-	-	na	-	-	-	-	-	0	na
- debt structure	+	-	0	+	-	-	-	-	-	0	-

Box II: Definitions of ratios used

(letters and numbers correspond to the Bach nomenclature)

1 GROSS OPERATING PROFIT RATIO:

Ratio of gross operating profit or loss to net turnover U/ 1

2 NET PROFIT RATIO:

Ratio of net profit or loss for the year to net turnover 21/1

3 FINANCIAL PROFITABILITY:

Ratio of profit or loss for the year to equity capital 21/L–A

4 RELATIVE SHARE OF PURCHASES OF GOODS AND SERVICES:

Ratio of consumption of goods and services to net turnover 5/1

5 VALUE ADDED RATIO:

Ratio of BACH value added to net turnover T/1

6 RELATIVE SHARE OF STAFF COSTS:

Ratio of staff costs to net turnover 6/1

7 STAFF COSTS RELATIVE TO VALUE ADDED:

Ratio of staff costs to BACH value added 6/T

8 RELATIVE SHARE OF FINANCIAL CHARGES:

Ratio of interest charges to net turnover 13a/ 1
(13a is replaced by 13 when the former is not available)

9 APPARENT RATE OF INTEREST ON FINANCIAL DEBT:

Ratio of interest paid on financial debt to debt owed to credit institutions with a remaining period to maturity of less than one year + other short term financial debt + financial debt with a remaining period of maturity of more than one year + bonds
NB: 13a, F101 and I101 are replaced by 13, F10 and I10 where the former are not available 13a/F2+F101+I1+I2+I101

10 RATIO OF FINANCIAL RESULT:

Financial result on net turnover W/1

11 OWN FUNDS RATIO:

Ratio of own funds less unpaid share capital to balance-sheet total L–A/FL

12 OVERALL DEBT RATIO:

Ratio of debt with a remaining period to maturity of more than one year + debt with a remaining period to maturity of less than one year to total liabilities F+I/FL

13 RATIO OF FINANCIAL INDEBTEDNESS:

Ratio of financial indebtedness balance sheet total F2+I2/FL

14 DEBT STRUCTURE:

Ratio of debt with a remaining period of maturity of more than one year to debt with a remaining period of maturity of more than one year + debt with a remaining period of maturity of less than one year I/I+F

15 RATIO OF PROVISIONS FOR LIABILITIES AND CHARGES:

Provisions for liabilities and charges to balance sheet total J/FL

Principal economic policy measures – June 1997

Community (EUR-15)

09.06. In the framework of the procedure of Article 103 of the Treaty, the Ecofin Council approves both the Broad Guidelines of the Economic Policies 1997 and the report on the implementation of the 1996 Broad Economic Policy Guidelines. Furthermore, the Ecofin Council examines the convergence programme of Ireland.

16./17.06. The Amsterdam European Council takes important decisions in view of the start of EMU and its successful functioning. The Council adopts:

- a resolution regarding the implementation of the Stability and Growth Pact for ensuring budgetary discipline and agrees, as part of the pact, on two Regulations which set a framework for effective multilateral surveillance and give precision to the excessive deficit procedure.
- a resolution on Growth and Employment, laying down the commitment to keep employment firmly at the top of the agenda. Sound macro-economic and budget policies go hand in hand with sustainable growth in output and employment.
- a resolution on the principles and fundamental elements of a new exchange rate mechanism (ERM 2). In addition, agreement is complete on two Regulations which constitute the legal framework for the euro. Furthermore, the European Council agrees with the Broad Guidelines of the Economic Policies 1997.
- The European Council also concludes the IGC, with agreement on a draft Treaty. A new title on Employment will be added to the Treaty. This will provide for a better co-ordinated employment strategy.

Belgium (B)

None.

Denmark (DK)

11.6 An agreement is reached between the Ministry of Finance and the County Councils in Denmark, whereby counties are allowed to increase local taxes. Tax rates will increase by 0.5 percentage points (on average) in 1998 in order to allow for higher local government spending in the health sector.

17.6 An agreement is reached between the Ministry of Finance and the National Association of Local Authorities in Denmark, whereby municipalities will be allowed to increase local taxes marginally. Tax rates are likely to increase by 0.1–0.2 percentage points (on average) in 1998 in order to allow for higher local government spending.

Germany (D)

4.6 The German Finance Minister Theo Waigel announces the immediate enforcement of a budget freeze ("Haushaltssperre") to further tighten the control on government spending. Under this budget freeze, expenditures above DEM 1 million require the explicit approval of the Finance Minister. The effect of such a budget freeze on the government deficit is rather limited: the budget freeze is expected to produce savings of around DEM 2 to 3 billion (0.1% of GDP) at most.

19.6 A compromise on the revaluation of the Bundesbank's gold and foreign exchange reserves is reached. A revaluation of the Bundesbank's foreign exchange reserves could take place at the end of 1997. In line with the Bundesbank's normal accounting practices, this would only affect the Bundesbank's profits in April 1998. A revaluation of the gold reserves will take place in the framework of the transition to the third stage of EMU. It is therefore clear that this issue will no longer affect the 1997 government budget.

Greece (GR)

None.

Spain (E)

26.6 The parliament approves a law on a progressive reform of the public pensions system up to the year 2000. Among other issues, the reform gradually raises the base for calculating retirement pensions from the last 8 to the last 15 years of work, makes a clear distinction between the funding sources of each pension and benefits regime, and guarantees pension increases in line with inflation.

France (F)

25.6 The government increases the minimum wage (SMIC) by 4% as from 1st July.

Ireland (IRL)

None.

Italy (I)

18.6 The government starts negotiations with union and employer representatives in order to reform the Italian welfare state and bring pension expenditure under control.

21.6/25.6 The Chamber of Deputies (on 21 June) and the Senate (on 25 June) approve the "Documento di Programmazione Economica e Finanziaria" (DPEF) which defines the expected macroeconomic scenario, the guidelines for policy action and the budgetary targets, covering the years 1998–2000.

Luxembourg (L)

None.

Netherlands (NL)

None.

Austria (A)

12.6 During a two day closed meeting the coalition government agrees on installing a common working group for preparing a reform of the Austrian pension system. The coalition also agrees on measures to consolidate the general government budgets in 1998 and 1999.

Portugal (P)

16.6 The EDP (an electricity producer and distributor) privatisation raises PTE 390 billion.

26.6 The government announces a tax reform comprising changes in property, financial operations, and vehicle taxes. The tax reform is to be implemented from 1998 onwards.

Finland (FIN)

None.

Sweden (S)

None.

United Kingdom (UK)

6.6 The Bank of England increases the base rate to 6½% from 6½%.

12.6 The Chancellor announces a change in the target for underlying inflation. It is fixed at 2½% rather than "2½% or less".

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